

BUSINESS MANAGEMENT

*Training and Service
for Executive Work*

*Financing Exports
and Imports**
Financing for
Expansion*

LA SALLE EXTENSION
UNIVERSITY
C H I C A G O



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BUSINESS MANAGEMENT

Executive Manuals 47 and 48

FINANCING EXPORTS AND IMPORTS—Being Executive Manual 47, on Financing a Business, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
staffs of LaSalle Extension University*

Especially acknowledging
the advice and co-operation of

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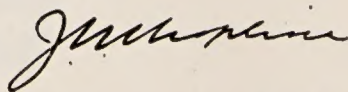
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FINANCING EXPORTS AND IMPORTS

Part I

PRACTICAL PROCEDURE

WITHIN two years one manufacturer of stationery in the United States built up an export business from an original order of less than \$5,000 to an annual volume exceeding \$150,000; and all of this export business was confined to the Scandinavian Peninsula. When the manufacturer found that this particular field offered promises of attractive profits, he concentrated on it. He did not scatter his energy in other overseas markets.

"I expect to reach out for more business in foreign countries," he said, "but I will not undertake further development until I have made a thoro analysis of the prospective territory by sending out personal representatives, interviewing the banks, and making extensive inquiries. Thus I shall have facts that will be a dependable guide in further developing foreign sales territory."

Fundamental Marketing Principles Apply to Foreign Trade. The plan and procedure of this manufacturer were really simple; they were no different, in principle, from the course often pursued in opening up new home markets. The business practices that prevail in foreign trade are, in fact, much the same as those in domestic trade.

The business man who begins to think in terms of overseas commerce can develop a satisfactory volume of export business by following out plans which are, in principle, similar to those that have been successful in his own country.

True, there are certain differences of detail and technical procedure in handling foreign and domestic trade, but they are not fundamental differences—not a real obstacle to the enterprising business man.

Let us first consider some of the incidental problems that confront the American business man who is planning to sell his goods abroad or who is buying merchandise in foreign lands.

Definite Information and Quotations. After you have made a thoro study of the Spanish market, for example, and have decided to enter that territory, a logical starting point is to determine how much your prospective customers know about your product and your methods. Have they purchased goods like yours from a competitor, and are they familiar with the way business is handled by Americans? And how should quotations be made? If the foreign buyer indicates that he is not wholly familiar with your goods and your methods, you must be sure to give him, in a direct and simple form, complete information as to what you propose to furnish, where delivered, at what price, under what terms, etc.—all essential details; for—

It is only by making certain that both buyer and seller understand each other fully that a foreign market can be profitably developed.

Sometimes the American exporter is disposed to make quotations that are more convenient for himself than for the buyer. When he does this, his chances for securing desirable business are lessened. He must protect himself against incurring greater expense than is necessary to secure the business, but he must not lose sight of the fundamental principle of successful salesmanship, emphasized in Executive Manual 20, that the seller must understand the buyer's viewpoint and cater to the buyer's interests.

The problem of making quotations, terms, and all essential details plain and complete in the buyer's mind is important to the seller as well as to the buyer. The seller wants sales and profit. The buyer wants to know the cost to him; he wants to determine definitely whether

or not he can sell at a profit or use to advantage what he contemplates buying.

Kinds of Quotations. Transportation charges are an important factor in all foreign-trade transactions. They comprise a considerable item in the cost of goods purchased by the foreign buyer. He must base his selling prices and his selling plans to a large degree on the cost of goods delivered at his place of business. The American business man knows his own costs—production, administration, and selling—and he is in the habit of basing his quoted selling prices on these costs, making allowance for profits and for domestic transportation charges with which he has of necessity familiarized himself. Moreover, trade practices in this country are fairly well standardized in many lines, so that buyers and sellers know when it is customary to quote “delivered” prices, and when it is not. Thru constant studies of traffic rules, rates, classifications, etc., both buyers and sellers know how to make allowances for transportation charges in figuring selling prices and purchase costs. But in foreign trade it is often the case that neither buyer nor seller is familiar with transportation charges, and it is here that some of the principal difficulties arise in agreeing on price quotations.

For these reasons the seller is usually interested in an F.O.B. quotation—free on board cars at seller’s shipping point; while the buyer prefers a C.I.F. quotation—cost, insurance, and freight: meaning that freight and insurance charges are paid to destination, or at least to some port in the buyer’s country. The seller, however, is just as much interested as the buyer in keeping down the price, in order, first, to help the prospective customer conclude that he can sell or use the goods profitably, and, second, to prevent the order from being placed with a competitor.

And in order to figure closely on a C.I.F. quotation, the seller must know what the total outlay will be to

handle the order on that basis as compared with a basis of, say, F.O.B. his city. He must add to the latter the difference involved in the cost of packing for export as well as the freight, insurance, and handling charges to destination.

Thus, while it is seldom possible for a seller to have a quotation F.O.B. his shipping point accepted, it is nevertheless always the starting point in figuring a C.I.F. quotation.

F.O.B. quotations are frequently fixed for a point other than the seller's city, such as F.O.B. New Orleans, when that is not the original point of shipment, but the port of embarkation. Such a quotation, therefore, includes the expense of getting the goods from the point of origin to New Orleans.

And when the quotation is F.A.S. (free alongside), the seller has the expense of transporting the goods from the point of origin to the railroad terminal, and thence to the ship.

Various Quotations Compared. Suppose you are a manufacturer at Bristol, Pa., and that I am a buyer at Mercedes, a city just west of Buenos Aires, in the Argentine. I ask you for your prices. You may quote me F.O.B. cars at Bristol. In this case, you simply pack the goods and deliver them to the railroad company, and I pay all the other charges and assume all the risks.

Or you may quote me F.O.B. cars at Philadelphia. In this case you pay the freight to Philadelphia and assume the risk of getting the goods there. I must pay for the cost of getting the goods from the railroad to the boat, and thence to destination.

If you quote F.O.B. cars on dock, or F.O.B. cars on barge alongside, you pay the expense of getting the cars switched to the dock or of having the goods delivered on barges alongside the ship. I will have to pay the expense of getting the goods on board if it is necessary to have

any special equipment for this purpose. This quotation is similar to F.A.S. Philadelphia. It requires you to bring the goods alongside by placing them either on the dock or on a barge or lighter alongside. The initials, F.A.S., stand simply for "Free Alongside."

So far you have not assumed any risk on the ocean. But suppose you quote C.I.F. Buenos Aires. This means that the quoted price includes costs (that is, the net price you place on the goods) plus insurance and freight to Buenos Aires, but that you do not assume the risk of shipment or agree to deliver the goods there.

In an F.O.B. quotation, you agree to deliver the goods at a certain point; and if they are accidentally destroyed before they reach that point, you must replace them. If, however, the quotation is merely C.I.F. that point, you have not agreed to deliver them there, but you have merely agreed to send them to that point and to pay the insurance and freight. In case of loss, you do not have to replace the goods, and the buyer's rights are against the insurance company only, unless the carrier is also liable, and provided that you have complied with all stipulations.

There is still the quotation F.O.B. dock at Buenos Aires. If you make this quotation, you assume all risk of getting the goods laid down on the dock at the foreign port.

In addition to these quotations, others are sometimes used, such as C.A.F. or C. & F. (cost and freight), which is the same as C.I.F. except that the buyer pays for the insurance. In dealing with the Far East, the term C.I.F.C.I. (cost, insurance, freight, collection charges, interest) is often used. Here the seller pays interest and collection charges as well as insurance and freight.

Importance of Definite Quotations. The importance of being specific in making quotations is apparent. F.O.B. quotations, for example, must always specify definitely

where the seller will place the goods F.O.B. Failure to do this has been the cause of many disputes. Furthermore, it is not sufficient merely to quote F.O.B. at the port of embarkation, as, for instance, F.O.B. New York. The purchaser usually takes this to mean F.O.B. outbound vessel, while often the shipper, if the point of origin is inland, simply means delivery at the railroad terminal at that port. Then when the buyer is charged with more transportation than he anticipates, a brisk correspondence develops—and one party or the other eventually finds his profits reduced by expenses on which he had not figured with mutual dissatisfaction as the result.

The cost and the difficulty of settling differences of opinion tend to increase with distance.

When you are dealing with a buyer in a far-off country, you are limited in your ability to argue thru correspondence, chiefly because it sometimes takes months for your letter to reach your customer.

Do not quote F.O.B. St. Paul, but rather F.O.B. works in St. Paul, or F.O.B. cars in St. Paul. Do not quote F.O.B. Boston, but say whether you mean F.O.B. cars at railroad freight station, F.O.B. cars on dock, or F.O.B. steamer. Quotations cannot be made too definite.

The same applies to C.I.F. quotations. In the case of seaports, do not quote simply C.I.F. the port of export, but C.I.F. Liverpool, or C.I.F. Bordeaux, etc.; that is, C.I.F. the port of destination. And with foreign inland cities, quote C.I.F. railroad station or warehouse, according to where you are actually offering to deliver the goods at the price quoted.

Basis of Financing Foreign Shipments. The financing of a foreign transaction does not differ greatly from the financing of a domestic transaction. We have already seen how acceptances—bills of exchange—facilitate financing in domestic commerce by making possible extensions of credit to buyers and the quick realization of

cash settlements by sellers. The use of bills of exchange in financing foreign transactions is, in principle, the same. There is the time factor, just as in domestic trade where credit is employed instead of money. In foreign bills of exchange, however, the time factor is more pronounced. There is a transportation factor, but with more complications, as suggested in preceding pages.

There is also the money-exchange factor, arising from the differences in value between the standard units of money in various countries, such as the mark in Germany, the pound in England, and the franc in France.

Since money represented by the value of goods in transit is tied up for a considerable time in foreign transactions, it is only natural that both buyers and sellers find it profitable to make use of bank credit. This they may do in various ways, to be explained later on. The main point to be emphasized here is that—

While payment to close a foreign transaction is not usually made direct from buyer to seller, the use of intermediaries—such as banks, discount houses, export and import agencies—does not make the transaction inherently different from that in domestic trade.

The various intermediaries perform valuable services in providing credit facilities and effecting final payment in the currency of the seller's country.

We have already seen how various credit instruments have come into use in facilitating financial settlements of domestic transactions, as when installment sales are closed by notes, on which the seller may realize immediate funds by negotiating them thru banks or special credit agencies. Thus, too, sales made on credit may be closed by trade acceptances or bank acceptances, which are negotiable bills of exchange on which the seller can realize ready money without requiring immediate payment from the buyer.

We have also seen how these credit instruments, representing live transactions in valuable goods, can be secured

by the goods themselves—by liens, conditional-sales contracts, trust receipts, insurance certificates, shipping documents, etc. We have only to remember why and how these various instruments come into being in domestic transactions to understand clearly the practices which have grown up to facilitate the financing of foreign trade.

Intermediaries in Foreign Settlements. The theory on which foreign-trade financing has grown up is basically simple. It is only when a large number of intermediaries enter into a transaction that operations become complicated. First, then, let us consider the basic procedure. Usually a bank at a seaport acts as an intermediary for the seller in financing the shipment between the time it leaves the factory or warehouse and the time it arrives at the foreign destination agreed upon in the terms of sale. The bank does this by discounting the seller's draft against shipping documents, drawn according to the terms of sale.

The draft may be payable at sight, which, of course, means that it is to be paid immediately upon presentation to the buyer. Or it may be payable in a certain number of days after sight, usually 30, 60, or 90 days; or, more rarely, it may be payable so many days after the date on which it is drawn. In either case, it is known as a time draft. Drafts are, as a rule, negotiated (sold or discounted), or they may be presented for "acceptance" and collection later thru regular banking channels.

The fees charged by banks for negotiating foreign bills of exchange vary with changes in the rates of foreign exchange, the terms of the draft, and the time for which the money must be advanced.

Banks play an exceedingly important part in financing the bulk of foreign trade. They bridge the gap between the American who is selling abroad, but desires payment before the merchandise leaves the American shore, and the buyer in a foreign country who is unwilling to part with his money until the goods are delivered.

METHODS OF SETTLEMENT

Banks may supply credit to the seller or to the purchaser, or to both. There are numerous ways of effecting settlement on foreign transactions, in all of which banks figure to a large extent.

Cash with Order. First, we have the method of paying cash with the order. The foreign buyer may remit with his order a draft on a New York bank. This method places the burden entirely on the buyer, and is employed chiefly in small transactions or where a special condition justifies its use. But even in such cases the buyer usually obtains the necessary credit from his own bank.

Cash on Delivery. Next is the plan of cash on delivery. The purchaser may send funds directly to an American bank, with instructions to pay the manufacturer upon delivery of certain documents, such as the export license, bills of lading, insurance certificates, invoices, and so on.

Sales on Open Account and on Consignment. Again, there are sales on open account. The exporter may permit the buyer to carry a running account under an agreement that payments will be made at specified periods. This practice is very uncommon, however, and is restricted to transactions between concerns that have had long-time dealings with each other out of which mutual understandings have grown as to all details and particulars of making shipments, extending credit, receiving goods, and so on. But even in such cases it is usual for the exporter or the importer, or both, to avail themselves of the facilities of bank credit in financing their transactions.

Shipments on consignment are sometimes made by exporters to resident agents or salesmen in foreign lands, with instructions to sell the goods while they are in transit. This practice, like sales on open account, is seldom followed.

The Confirmed Order. There is also the confirmed order.

Ways of Financing Foreign Shipments

METHODS	PARTIES INVOLVED	WHEN DOES SELLER RECEIVE HIS MONEY	WHEN DOES BUYER PART WITH HIS MONEY	WHO ASSUMES THE RISK ?
CASH WITH ORDER	Buyer and Seller	Before He Ships the Goods	Before Seller Ships Goods	The Buyer Thruout
CASH ON DELIVERY	Buyer, Seller, and Bank in Seller's Country Representing Buyer	On Presenting Draft and Documents to Buyer's Correspondent in Seller's Country	When He Sends the Order for the Goods	The Buyer After Goods Are Paid for
OPEN ACCOUNT	Buyer Seller	At Specified Periods Long After Goods Are Shipped	At Specified Periods After He Has Received Goods	The Seller Thruout
COMMERCIAL DOCUMENTARY DRAFT (Sight Draft or Acceptance)	Buyer, Seller, and Seller's Bank	On Discounting Draft in Seller's Bank	When Goods Arrive, or in Time to Meet Acceptance	The Seller and His Bank
THE CONFIRMED ORDER (With Sight Draft or Acceptance)	Buyer, Seller, and House in Seller's Country Confirming Order	On Presenting Draft and Documents to Confirming House, or Discounting Acceptance	When Goods Arrive, or in Time to Meet Acceptance	The House in Seller's Country which Confirms Buyer's Order
LETTER OF CREDIT (Sight Draft Used)	Buyer, Seller, Buyer's Bank, and Its Correspondent in Seller's Country	On Presenting Sight Draft and Document to Bank Issuing Letter of Credit, or to Its Correspondent	When Goods Arrive	Bank Issuing Letter of Credit
LETTER OF CREDIT (Acceptance Used)		When Acceptance Matures, or Earlier by Discounting	In Time to Meet Acceptance When It Falls Due	

Figure 1. Common methods of financing foreign shipments, indicating when seller receives his money, when buyer parts with his money, and placement of the risk.

A current practice is for the importer to make financial arrangements with a foreign house, or with a local establishment represented in the foreign country, to confirm his orders and pay for the merchandise. Under this arrangement the exporter need concern himself only with the credit of the house so designated.

Letters of Credit. Another way in which the seller may get his money at once while the buyer does not pay till he gets the goods, or later, is by use of the commercial letter of credit.

Let us suppose that Gaston et Cie of Paris wishes to buy of Johnson & Company of New York. Gaston et Cie will make arrangements with its Paris bank by which that bank will have its New York correspondent issue a letter of credit to Johnson & Company stating that it will pay drafts drawn on the Paris bank by Johnson & Company. Johnson & Company will then draw on the Paris bank, and present the draft to the New York bank that issued the letter of credit. The New York bank will pay the draft and send it to the Paris bank for credit, charging the account of the Paris bank for the amount paid. The Paris bank will then reimburse itself by securing payment from Gaston et Cie.

Practically the same procedure is followed when the letter of credit authorizes the shipper to draw on the issuing bank, instead of the foreign bank.

There are a number of important benefits derived from the use of letters of credit:

1. The seller has the guaranty of the bank issuing the credit that drafts drawn will be honored, provided he fulfills the conditions of the credit.
2. The buyer has assurance that he will receive value in the form of documents representing shipment of merchandise.
3. The seller has no difficulty in discounting his drafts with his local bankers; while the buyer does not pay for his purchase until the arrival of the documents, or perhaps later.

The third benefit enumerated brings up the points of the marketability of the draft and the price for which it can be sold. A draft accepted by any bank of high standing is quite certain of payment at maturity and therefore commands a high market price—or a low rate of discount. A draft on a foreign trading concern or manu-

CAPITAL, SURPLUS AND UNDIVIDED PROFITS \$45,000,000

Continental and Commercial National Bank

of Chicago

FOREIGN DEPARTMENT
W. G. MACKINTOSH, MANAGER
A. W. ROBERTS, ASST. MANAGER

CABLE ADDRESS "CONTCONMAT"
PETERSONS
L. EBERS
A. B. C. S. D.
WESTERN UNION
BENTLEY'S
BROOKHALLS

Chicago, January 10th, 1925.

To John Doe & Company, Inc., EXPORT CREDIT
10 South State Street,
Chicago, Illinois. No. 50005.

Dear Sirs:

In accordance with cable instructions received from Banco Hollandez de la America del Sur, Santos, Brazil,
we opened a revocable credit in your favor for account of The South American Import Company, Santos, Brazil,
Amount \$ 50,000.00 (Fifty Thousand - - - - - Dollars)
covering shipment of coffee cleaning machinery from New York to Santos, Brazil.

Drafts under this Letter of Credit are to be drawn at sight on us
and are to be accompanied by a set of shipping documents
of a character which must meet with our approval, consisting of:

Shipper's invoices
Consular invoices, if such documents are required in connection with this shipment.
Marine and War Risk Insurance Policies
Full set of ocean steamer bills-of-lading made out to order and endorsed in blank,
or to the order of the Banco Hollandez de la America del Sur,

It must be understood that payments under this credit will only be made provided the goods are actually on-board or loading on the vessel named in the B/L.
Marine insurance should cover from warehouse to warehouse, and not less than ten days after arrival, and also include deviation clause, craft and lighter clause, negligence and/or latent defect clause. Policies reading free of particular average completely, must not be tendered without prior arrangement with us.
The documents should be presented whenever possible in time to be forwarded on the steamer carrying the merchandise.

This Letter of Credit expires March 31st, 1925, unless sooner revoked.

If you are unable to comply with the terms as indicated above, please communicate with us promptly, and oblige

Yours respectfully,

Continental & Commercial National Bank of Chicago.

Figure 2. Revocable Credit. Example of a revocable letter of credit covering the export of machinery to Brazil.

Guaranty Trust Company of New York

Foreign Offices

140 Broadway

London
Liverpool
BrusselsParis
Geneva
Amsterdam

New York

January 3, 1925.

TO- American Flour Export Company,
Kansas City, Mo.

For routing please refer to
EXPORT CREDIT NOC21769

Gentlemen:

In accordance with cable instructions from The Bank of the Golden Horn, Constantinople, Turkey, we have established an irrevocable credit in your favor for account of Omar, Constantinople,

for \$15,900.00 - Fifteen thousand, nine hundred----- Dollars
available by your drafts at sight on us.

secured by shipping documents of a character which must pass with our approval
consisting of

Commercial invoices

Consular invoices if such documents are required in connection with this shipment

Marine and War Risk Insurance policies with particular average 3% each 10 sacks.

Full set of ----- on board ----- ocean steamer BILLY LANE made out to the order
of the Bank of the Golden Horn, Constantinople, -----

covering shipment of 4800 sacks of AMPLIX brand flour at \$5.30 per 100 kilos,
shipment during January and/or February, 1925, from any Atlantic port
c.i.f. Constantinople.

The Credit expires March 7, 1925.

If you are unable to comply with the terms as indicated above, please communicate with us promptly.

Yours respectfully,

N. B.—Whenever possible, the documents should be presented to us to be forwarded by the steamer carrying the merchandise.

Figure 3. Irrevocable Credit. Example of an irrevocable letter of credit, covering the export of flour to Turkey.

factorer will not present such attractive features to prospective purchasers of bills of exchange.

Letters of credit may be either specific, for payment of a certain draft or drafts, or blanket, covering any number of drafts, provided the total amount outstanding does

not exceed a certain sum. A form of blanket letter is the revolving letter of credit, wherein the terms of the credit permit the seller to draw in payment of his invoices up to the limit of the credit; then the credit becomes available immediately for similar drawings when earlier drafts have been paid.

Letters of credit usually go into detail both as to the conditions of the draft, as to just how it shall be drawn, and also as to what papers shall accompany it, as in the two examples here shown in Figures 2 and 3. All the conditions must, of course, be complied with.

If the bank issuing a letter of credit reserves the right to revoke it before the stated date of expiration, it is called a revocable (unconfirmed) letter of credit. Ordinarily, "unconfirmed" is considered synonymous with revocable, and "confirmed" with irrevocable; but the American Acceptance Council has divided letters of credit into three classifications: revocable, irrevocable, and irrevocable-confirmed, which is explained as follows:

"The irrevocable letter of credit may be strengthened further by having the notifying bank in the same country as the exporter add its unqualified assurance that it will pay or accept the bills drawn by him even if the foreign bank should refuse to honor them. It is then called a confirmed letter of credit. Expressing, therefore, both the definite undertaking of the issuer and also of the notifier, it is actually an 'irrevocable-confirmed' letter of credit." Thus—

In financing foreign trade the exporter has an advantage in drawing on an irrevocable (confirmed) letter of credit in comparison with revocable credit.

How the Exporter May Arrange for Financing. It is well at this point to study actual examples of financing foreign shipments thru the use of acceptances and letters of credit. Take, first, the case of an American exporter financing a shipment to a foreign country.

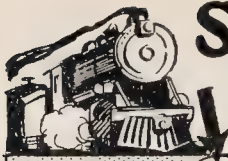
The Southern Cotton Co., of Houston, Tex., has pur-

chased, for \$120,000, 1,000 bales of cotton for export. The company wishes to ship to Liverpool on consignment, with the understanding that the shipment is to be sold there either before or after arrival. The purchase is immediately "hedged" on the New York Cotton Exchange by selling futures against it. (The operation of hedging has been explained in Executive Manual 46.) The firm then requests its bank to finance the shipment of the cotton by railroad from Houston to New York, whence it is to be shipped to Liverpool as soon as cargo space can be provided.

The bank, having agreed to finance the shipment, authorizes the Southern Cotton Co. to draw upon it, at 90 days' sight, for 80 per cent of the value of the cotton (amounting, in this case, to \$96,000), provided the railroad bills of lading covering the shipment are attached to the draft. The bank then accepts this draft, sells it in the open market, and places the proceeds to the credit of the Southern Cotton Co. The bills of lading (or the warehouse receipts, if the cotton is stored in New York awaiting cargo space) are retained by the bank as collateral security. In addition to that security, the cotton company signs an acceptance agreement pledging the 1,000 bales of cotton as collateral for the credit, and promising to place the bank in possession of funds to meet the draft at maturity.

Later, when cargo space can be arranged, the bank (or the cotton company's representative) will arrange to have the cotton placed on board a steamer sailing for Liverpool, and will receive the ocean bills of lading covering shipment.

The Southern Cotton Co. provides for marine and war-risk insurance to cover the cotton in transit to England, and turns the policies over to the bank. These policies, together with the ocean bills of lading, are then forwarded by the bank to its Liverpool correspondent with instructions to receive the cotton on the arrival of



STEP 1: Financing Shipment from Houston to New York

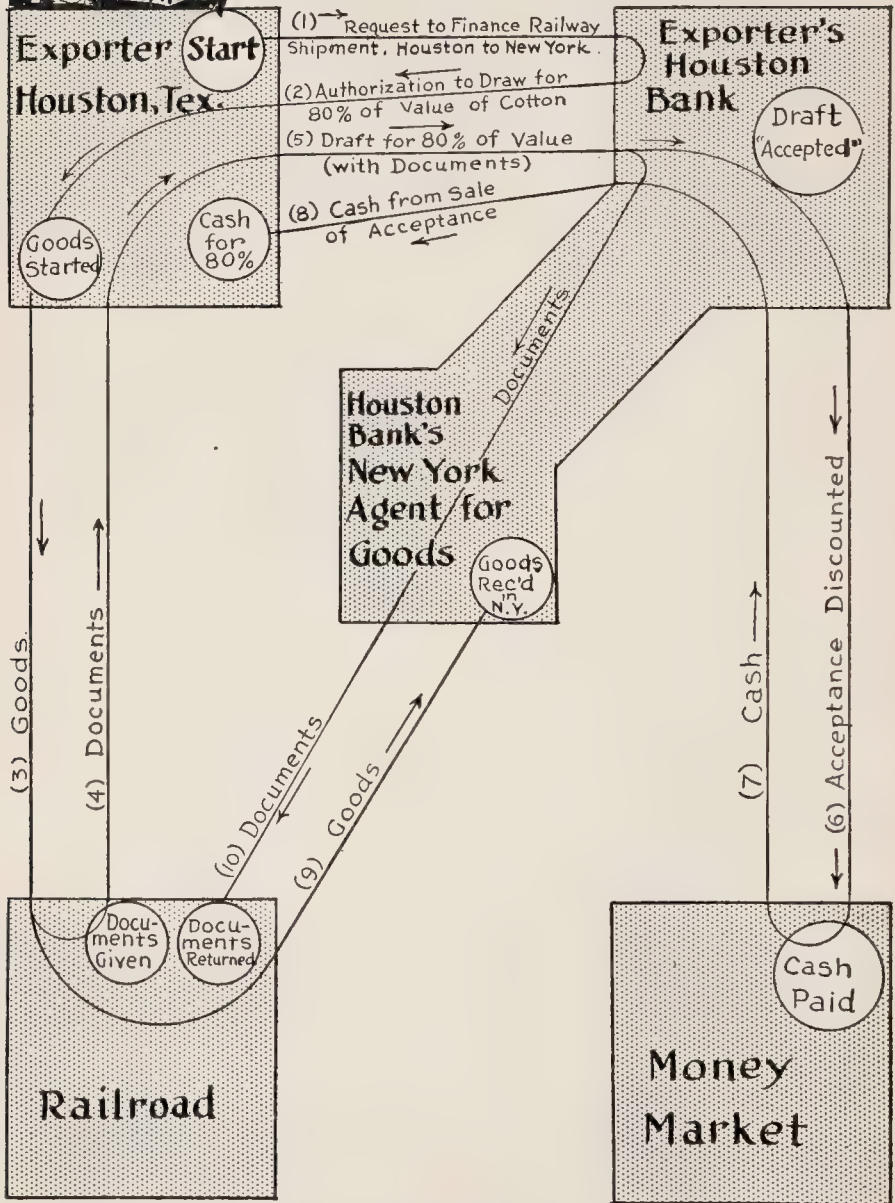
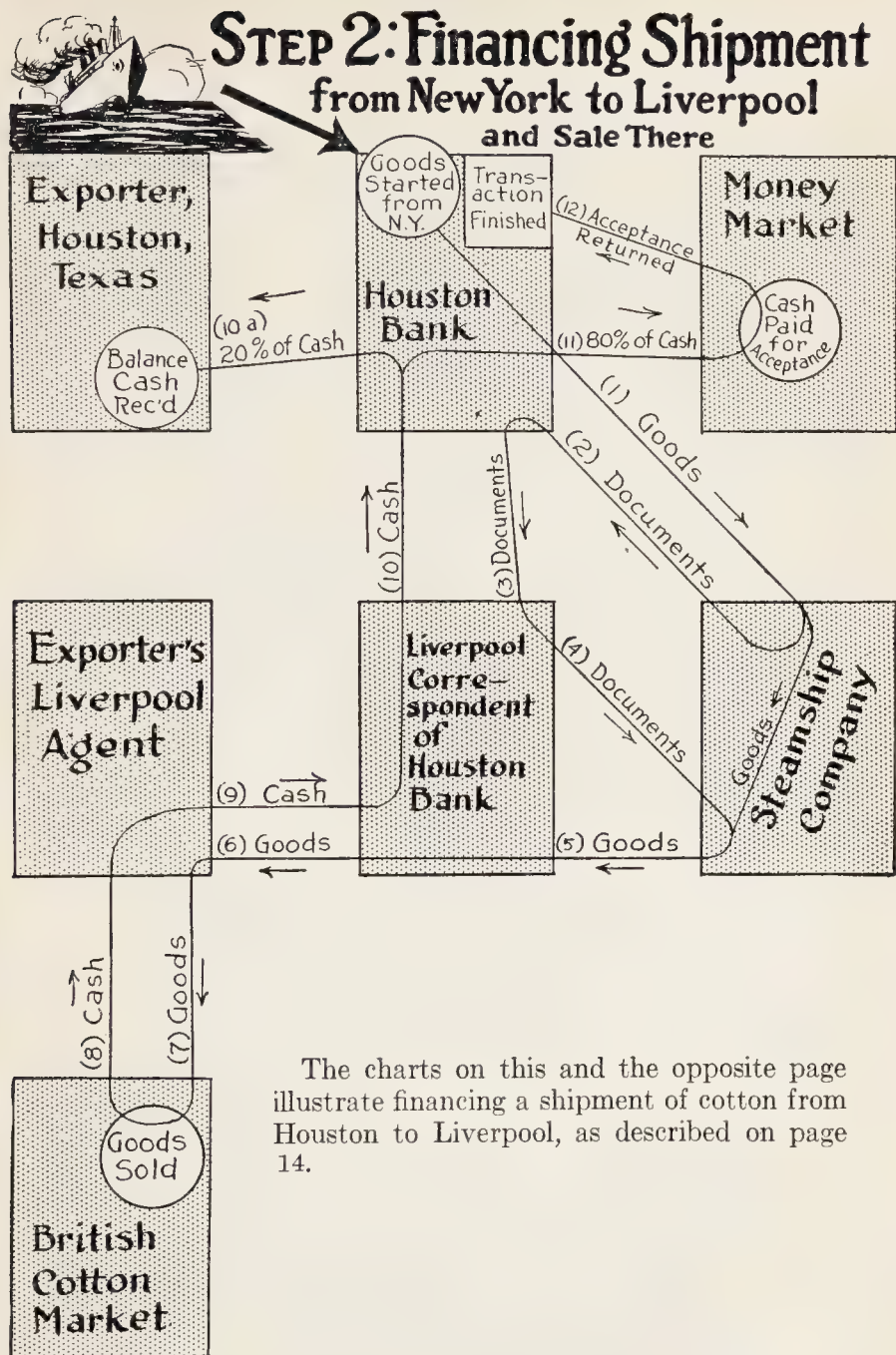


Figure 4. Step 1 in financing export shipment of cotton, as explained on page 14.



The charts on this and the opposite page illustrate financing a shipment of cotton from Houston to Liverpool, as described on page 14.

Figure 5. Step 2 in financing export shipment of cotton.

the steamer, and to place it in a warehouse pending further instructions.

The Liverpool agents of the shippers (the Southern Cotton Co.) are notified of the shipping of the cotton, and they immediately proceed to sell it. Upon being notified of the sale, the American bank instructs its Liverpool correspondent to deliver the bills of lading or warehouse receipts to the buyer against payment of the amount of the invoice in English currency, or against an agreement to pay the invoice within ten days.

On payment of the invoice, the amount collected by the Liverpool bank is placed to the credit of the bank in the United States, and the latter is advised of this fact. The Houston bank then converts the amount into dollars, at current rates for cable transfers on London, and applies the proceeds to the payment of its acceptance. The bank may receive these funds before its acceptance matures, in which case it rebates the interest between then and maturity, which interest has been charged to the Southern Cotton Co. And thus the transaction growing out of the consignment of the 1,000 bales of cotton is completed.

Where the Buyer Finances an American Shipment. Turn now to a case of financing a foreign shipment by the buyer in a foreign country.

A firm in Argentina has ordered from the New England Cotton Mills dry goods amounting to \$100,000 in value, and has arranged with its banker there to finance the transaction on 90 days' credit. The Argentine bank asks a bank in the United States to accept a 90 days' sight draft drawn on it by the cotton company, provided such draft is accompanied by a full set of shipping documents covering the dry goods in question.

On receipt of these instructions, the bank in the United States issues a letter of credit to the cotton company notifying it of the opening of the credit, and requesting

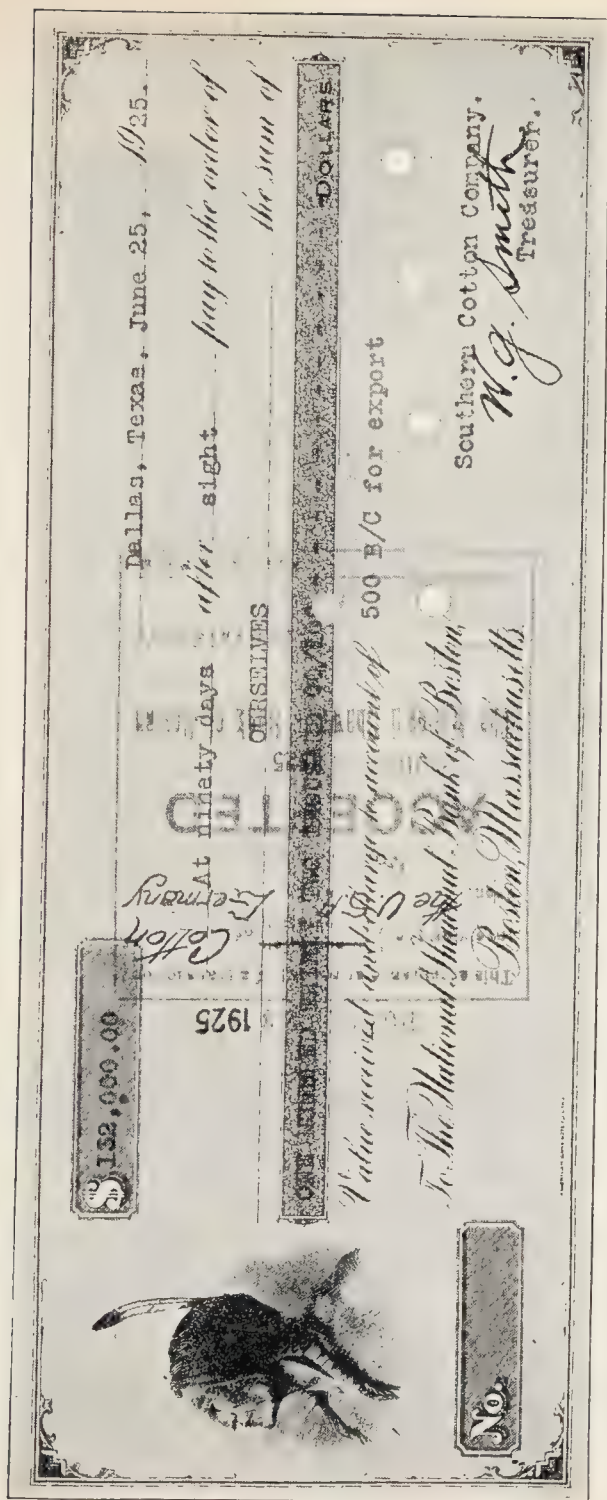


Figure 6. Time draft drawn on an American bank in financing an export transaction in cotton, as described on page 15. This draft, when accepted by the National Shawmut bank, becomes a bank acceptance, a bill of exchange which may be sold or discounted in the open bill market.

the cotton company to present draft and shipping documents within the time specified. Upon making shipment of the goods, the cotton company secures the bills of lading and attaches them, together with invoices, consular invoices, and insurance certificates, to a draft drawn at 90 days' sight on the bank in the United States. The bank accepts the draft on presentation, after satisfying itself that all conditions have been complied with.

The draft is now a banker's acceptance, and the cotton company can negotiate it thru its bank and receive the proceeds for the shipment, less the discount.

The documents are then forwarded by the bank in the United States to the bank in Argentina, which will be advised that a draft for the amount of the invoice has been accepted for its account against the documents. Upon arrival at the Argentine bank, the documents will be handled in accordance with that bank's usual custom or in accordance with any arrangement it may have made with its customer, who in this case is the dry goods house in Argentina. On maturity of the draft, the Argentine bank will have to deposit with the bank in the United States funds to enable the latter bank to meet its acceptance, plus the commission charged for issuing the acceptance.

Use of Acceptances in Financing Imports. Let us turn now to a method of financing imports with acceptances. Dorlin & Co. of Lowell, Mass., have purchased from the Yokohama Raw Silk Company, of Yokohama, Japan, 100 bales of raw silk amounting to \$25,570.15.

As soon as the details of the transaction are completed, Dorlin & Co. apply to their bank and obtain a letter of credit sufficient to cover the deal. The silk has been bought on four months' time, so Dorlin & Co.'s bankers issue the letter of credit authorizing the Yokohama Raw Silk Co. to draw upon it drafts at four months' sight covering the value of the shipment. The bank stipulates that a complete set of shipping documents must be at-


No.

\$97,570.00

Cotton
Goods
The Argentine

ACCEPTED
At ninety days after ourselves

PRESIDENT
Boston

Boston, Mass., June 29, 1925.

eight pay to the order of the sum of

ONE HUNDRED AND SEVEN THOUSAND NO. 100 DOLLARS

Value received with charge in account of L/C#518 Bank of Buenos Aires dated May 5, 1925.

To The National Bank of Boston
The National Bank of Boston, Massachusetts

NEW ENGLAND COTTON MILLS

L. S. J. Seller
Treasurer.

Figure 8. This is a form of bank acceptance whose use is described in connection with the financing of an export shipment of dry goods to Argentina (page 18).

tached to the draft, including the original invoice, the consular invoice, bills of lading, and insurance certificates.

The letter of credit is now handed to Dorlin & Co. to be forwarded by them to the Yokohama Raw Silk Co. In regular practice, deals like this usually call for immediate shipment of the goods, and it therefore becomes necessary that the bank cable to its Yokohama banking correspondent giving advice of the issuance of the credit and stating the terms and conditions. The correspond-

SHIPPING DOCUMENTS

A complete set of shipping documents consists of:

1. Invoice.
2. Complete set of ocean bills of lading.
3. Marine and war-risk insurance certificates or policies in duplicate.
4. Consular invoice.

Other documents, such as an inspection certificate, analysis certificate, weight certificate, and certificate of origin may be required, according to the terms of sale, the kind of product shipped, or the destination of the shipment. However, the majority of shipments require only the four documents previously mentioned.

INVOICE DATA

The invoice usually contains the following data:

- Date.
- To whom invoiced; name and address.
- Name and address of consignee.
- How shipped, name of steamer and route.
- Description of merchandise.
- Terms of sale.
- How packed.
- Weights: gross, tare, and net.
- Invoice price and how figured.
- Discounts or other deductions from invoice price; also petty charges or additions all itemized.
- Marks and numbers.

Figure 9. Above are the customary shipping documents and data required in the invoice covering foreign shipments.

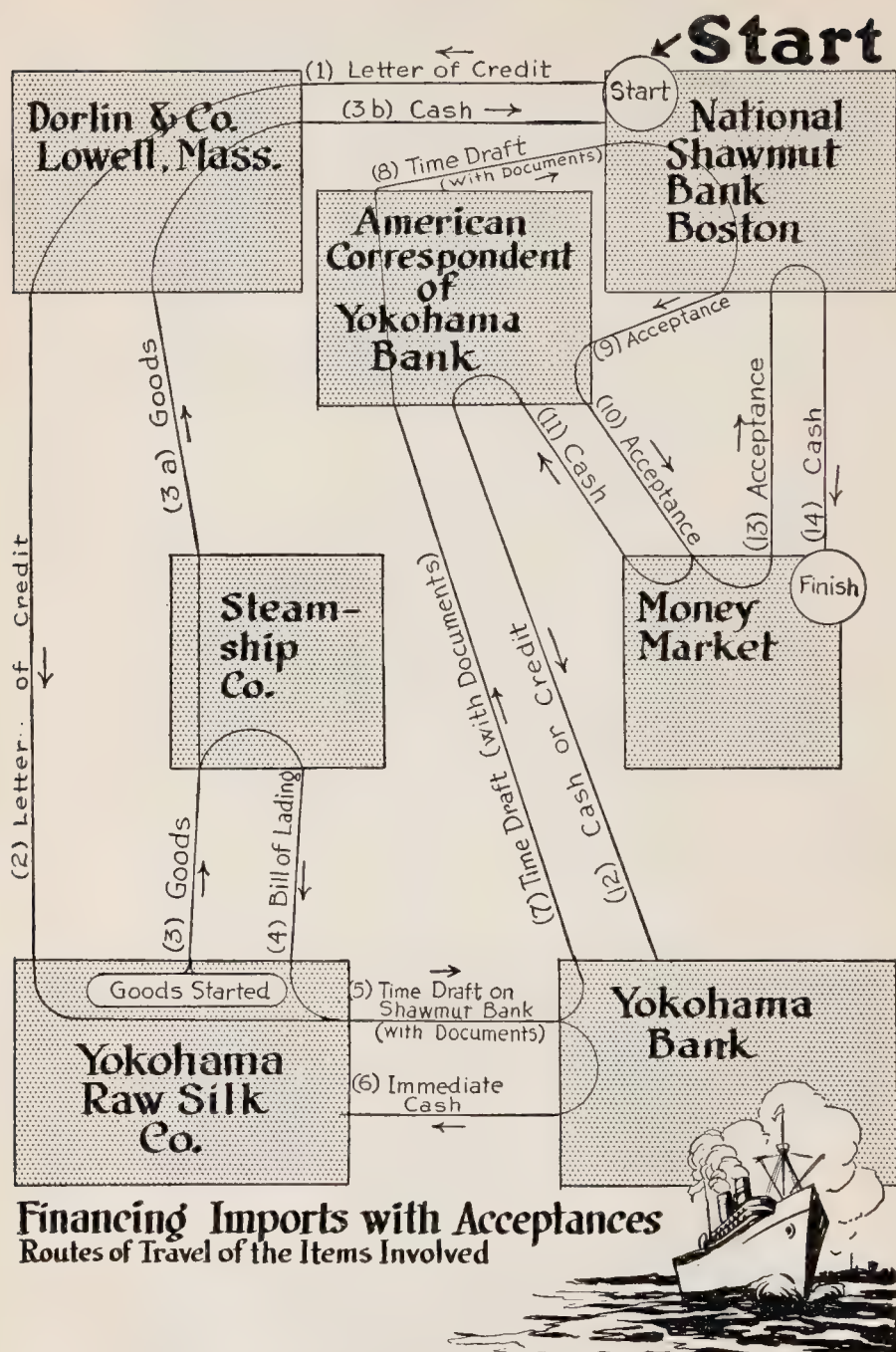


Figure 10. This diagram shows the procedure by which the American importer may finance a shipment from a foreign country.

Guaranty Trust Company of New York	
Letter of Credit No. 890524 For \$17,000.00 - U.S.C. Messrs. Guarini Mendoza & Co., Santos, Brazil. Gentlemen:	Foreign Department New York, January 3, 1925.
We hereby establish our irrevocable credit in your favor for account of James Williams & Co., New York----- available by your drafts drawn at --- 90 (ninety) days sight-----on the Guaranty Trust Company of New York, New York for any sum or sums not exceeding a total of Seventeen thousand dollars United States Currency----- accompanied by commercial invoice, consular invoice, ocean bills of lading evidencing Cost and Freight-----shipment of - 1000 (one thousand) bags Coffee during January 1925 from Santos, Brazil to New York----- Insurance is covered by the buyers. Ocean Bills of Lading must be drawn to the order of The Guarantee Trust Company of New York and dated not later than January 31, 1925.----- A COPY OF THE CONSULAR INVOICE AND ONE BILL OF LADING MUST BE SENT BY THE BANK OR BANKER NEGOTIATING DRAFTS, DIRECT TO THE GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK. The amount of each draft negotiated, with the date of negotiation, must be endorsed hereon. All drafts drawn under this Credit should bear the clause "drawn under G. T. Co. of N. Y. Letter of Credit No. 890524 dated New York, January 3, 1925. -to cover shipment of coffee----- from Santos to New York. We hereby agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation and delivery of documents as specified to the Guaranty Trust Company of New York, <u>New York</u>, if drawn and negotiated on or before ----- February 2, 1925. Yours Respectfully, 	

Figure 11. An irrevocable letter of credit issued by a New York bank, authorizing a Brazil coffee exporter to draw on it in United States dollars.

ent, in turn, notifies the silk company of the opening of the credit.

The Yokohama Raw Silk Company then proceeds to make shipment of the 100 bales of raw silk to the United States. When the silk is placed on board steamer, the

silk company obtains from the steamship company the bills of lading. It then draws its draft on the bank in the United States at four months' sight for the amount of the invoice. To the draft it attaches the bills of lading and other documents required, and takes the whole to its bank, which negotiates the draft and pays the proceeds in Japanese funds.

The negotiating bank, having purchased the draft, forwards it to its correspondent in the United States, with instructions that it be presented for acceptance to the American bank. If, upon inspection, the American bank finds that the documents are all in order, it accepts the draft and returns it to the presenting bank in the United States after detaching the bills of lading and other documents which it desires to hold as security against the acceptance.

The draft is now a bank acceptance and is eligible for purchase by a Federal Reserve Bank when having not more than three months to run, or it can be offered for sale to banks and commercial-paper houses in the open discount market. It can thus be negotiated and the proceeds placed to the credit of the bank in Yokohama, which is thus reimbursed for the money paid to the silk company at the time shipment was made.

All of the documents pertaining to this importation of raw silk being now in the possession of the bank in the United States, it notifies its customer, Dorlin & Co., of the facts. Upon arrival of the steamer carrying the silk, Dorlin & Co. request that the documents be turned over to them so that they may arrange for unloading the silk and for its entry at the United States customhouse.

Before surrendering the documents, the bank will require that Dorlin & Co. sign a "trust receipt" in which they pledge themselves to store the silk in a public warehouse, insure it adequately, and let the bank hold the warehouse receipt and insurance papers pending sales or delivery of the commodity.

In case of sale or delivery of the raw silk in storage, Dorlin & Co. sign a "trust receipt" pledging themselves to turn over to the bank the proceeds of the sale when they receive payment. (In many instances, where the bank allows merchandise so held to be sold, it requests that the invoice covering such sale be "accepted" by the

Amount £50,000-0-0 COMMERCIAL CREDIT No. C. 70006 ----
Opened by Cable
CONTINENTAL AND COMMERCIAL NATIONAL BANK
OF CHICAGO
 CHICAGO, ILL., U. S. A., January 10th 1925.

To Messrs. John Doe & Company,
 Calcutta,
 India.

Dear Sirs:

We hereby authorize you to value upon
Barclays Bank Limited, London, England -----
----- at Four Months (4) ----- sight for any sum or sums
 not exceeding in all Fifty Thousand Pounds -----
 For account of Wolf Rubber Company, Chicago, Illinois -----
 The Drafts must be drawn against shipment(s) of rubber from Calcutta to New York -----

----- and accompanied by bills-of-lading, shipper's invoice, consular invoice and
policies of insurance -----
including war risk to be
insurance effected by shippers ----- The Bills of Lading must be issued to the order of
shippers and endorsed in blank -----

 In every instance one Bill of Lading with Shipper's Invoice and consular certificate -----
----- must be sent by the first negotiating
bank direct to Barclays Bank, New York, New York -----
and a certificate by the first negotiating bank stating that this has been done, must accompany
each draft
 And we hereby agree with the drawers, endorsers, and bona fide holders of Drafts drawn
 under and in compliance with the terms of this Credit that the same shall be duly honored upon
 presentation at the counter of Barclays Bank Limited, London, England -----

This Credit remains in force to and including March 31st 1925, on or before
 which date Drafts hereunder must be drawn and negotiated.

All Drafts under this Credit must be endorsed hereon and marked as being drawn
 under CONTINENTAL AND COMMERCIAL NATIONAL BANK OF CHICAGO Letter of Credit No. 70006 -----
 dated January 10th 1925.

COUNTERSIGNED.

Yours very respectfully,

CONTINENTAL AND COMMERCIAL NATIONAL BANK OF CHICAGO.

Figure 12. Sterling Import Letter of Credit, showing how an American importer can use the service of an American bank in financing a foreign purchase in terms of pounds sterling.

Trust Receipt Commercial Credits Division

New York City, February 10, 1923

Received from the GUARANTY TRUST COMPANY OF NEW YORK, for one of the following purposes, as indicated by (x).

- ☐ 1. For Export Shipment.
☐ 2. For Warehousing.
☐ 3. To Exchange for Domestic Order Bills of Lading (Railroad or Steamship).
☐ 4. For immediate delivery to _____ who
 have/has purchased the same for \$ _____ payable _____
 and to obtain from the purchaser the proceeds of the sale.
☒ 5. For delivery to various buyers

the goods and merchandise specified in the documents described below, both such documents and said goods and merchandise belonging to and being the property of the said Trust Company, and in consideration thereof I/we hereby agree to hold said goods and merchandise in trust for it and as its property and to deliver over to the said Trust Company or its assigns, immediately upon the receipt thereof by me/us, and in any event not later than (Date) February 28 any one of the following representing the goods and merchandise described below according to the purpose for which the original documents are withdrawn:

1. ~~Complete Set of Order Ocean Bills of Lading.~~
2. ~~Negotiable Warehouse Receipts of Independent Warehouses, Inc., or other warehouses satisfactory to said Trust Company.~~
3. ~~Domestic Order Bills of Lading. (Railroad or Steamship.)~~
4. Proceeds of the sale of such goods or merchandise, it being understood that immediately upon receipt by me/us of such proceeds the same shall be delivered to the said Trust Company in whatever form collected and whether or not my/our obligation to it shall have matured. It is understood that such proceeds are to be applied by said Trust Company against my/our indebtedness to said Trust Company, whether due or to become due. However, if such proceeds be in notes, bills receivable or acceptances, they shall not be so applied until paid, but held until maturity by said Trust Company, with liberty meanwhile to sell or discount and so apply the net proceeds.
- 5.

The delivery herein is temporarily made to me/us for convenience only, without novation, or without giving me/us any title to the documents or the goods and merchandise they represent, except as trustee and agent for the said Trust Company for the purposes herein indicated.

Said Trust Company may at any time cancel this trust and take possession of said goods and merchandise or any of said documents or of the proceeds of the same wherever said goods and merchandise and documents or the proceeds thereof may then be found or located, and in the event of suspension, proceedings in bankruptcy or assignment for the benefit of creditors on my/our part or of the non-fulfillment of any obligation or of the non-payment at maturity of any indebtedness on my/our part to said Trust Company, then in any such case, all obligations, acceptances, indebtedness and liabilities whatsoever shall forthwith mature and become due and payable.

The said goods and merchandise shall at all times at my/our expense, be fully insured against loss by fire and any other risk that said goods and merchandise may be subject to. The insurance policies or certificates of acceptable companies in proper form showing loss, if any, payable to the GUARANTY TRUST COMPANY OF NEW YORK, will be deposited with it on demand.

The undersigned in further assurance, agree that insofar as the undersigned may make entries or records of transactions herein set forth or provided for in the books of account of the undersigned, such entries shall definitely indicate that said merchandise and documents and the proceeds thereof are the property of said Trust Company.

Receipt of a copy of this Trust Receipt is herewith acknowledged.

DESCRIPTION OF DOCUMENT	QUANTITY	GOODS AND MERCHANDISE (GIVE MARKS AND NUMBERS)	VALUE
2 Bills of Lading	1000 bags	Coffee J. W. Co. B-1/8	\$16,823
1 Consular Invoice			
1 Commercial Invoice		Under L/C No. 890524	

Signed James Williams & Co.

Figure 13. Example of a Trust Receipt covering documents received under a letter of credit and surrendered to the American importer.

buyer, and assigned and made payable to the bank.) Thus—

If the financial standing of the importer warrants it, merchandise may be delivered to the importer under a trust receipt—the importer either to pay as the merchandise is sold, or allowed to retain funds received from sales and pay in full when the bank's acceptance is due.

The substance of these trust receipts is simply that the merchandise remains the property of the bank and is released to the customer on his promise that he will deliver to the bank within a given time other documents representing the same merchandise or the equivalent in cash.

Attention to Detail Is Essential. When a sale is made (or when a shipment is made as in the case of the Southern Cotton Co. transaction), it is important to determine to whose order the documents should be drawn. This applies especially to bills of lading, to warehouse and other receipts, and to insurance certificates.

Shipping papers are usually drawn "to order" of the shipper because of the flexibility of negotiation thus obtained by the indorsement of the shipper; but this is not permitted in some countries. The indorsement of the shipper should be made in blank, and not to the bank accepting the papers. By agreement between the parties, however, bills of lading are sometimes issued directly to the consignee. In this way the buyer makes certain that the goods cannot be diverted without his consent. The law of the importer's country must also be consulted, as several countries require the bills of lading to conform to certain specific regulations.

Details and regulations must be attended to with the utmost care and thoroughness so that in case something goes wrong with a foreign shipment, liability can be definitely fixed.

This fixing of liability is one of the most important factors affecting foreign trade.

(Number)

New York, January 3, 19 23

THE GUARANTY TRUST COMPANY OF NEW YORK,
140 Broadway, New York City

Dear Sirs:

We enclose for collection
as collateral for an advance the undermentioned draft with documents as enumerated. Instructions concerning the surrender of the documents attached to the draft will be found below

DRAFT		NUMBER	DOCUMENTS
No.	6824	2	Commercial Invoice
Date	January 3, 1923	1	Consular Invoice
Amount	\$13,429.41	3	Bills of Lading
Tenor	120 days date	2	Insurance Certificate
Drawer	Ourselves	-	Certificate of Origin
Drawee	Shanghai Trading Corporation	-	Weight Certificate
City Where Payable	Shanghai, China	-	Declaration of Shipper

INSTRUCTIONS INDICATED BY "X"

- ☒ Documents against ~~Payment-~~
Acceptance
- ☒ Protest for ~~Non-Payment~~
~~Non-Acceptance~~
- ☐ Do not protest.
- ☒ Permit Drawee privilege inspecting merchandise before accepting draft.
- ☒ Hold for arrival of goods.
- ☒ Payable at collecting banks selling ~~Check~~
Cable rate on New York on day of payment.
- ☐ Payable at Check rate on New York, remitting proceeds by cable, charges for our account
- ☒ Interest to be collected at 6 % from date of issue until approximate arrival cover in New York
- ☒ Allow Drawee interest at 6 % per annum for anticipated payment.
- ☒ All charges are for account of ~~Drawer-~~
Drawee
- ☒ Waive charges if refused by Drawee.
- ☐ In case of need refer to
- Remarks: Should you designate "in case of need" give specific instructions concerning the authority extended
- ☒ In case of ~~Non-Acceptance-~~
~~Non-Payment~~ advise immediately by ~~Mail-~~
Cable
- ☐ Special Instructions

Protest of items drawn on Colombia and Peru is waived

It is understood and agreed that, having exercised due care in the selection of any correspondent to whom the above mentioned item may be sent for collection you shall not be responsible for any act, omission, default, suspension, insolvency or bankruptcy of any such correspondent or its sub-agent, or for any delay in remittance, loss in exchange or loss of said items or their proceeds during transmission or in the course of collection.

Yours truly,

J. K. and L. M. ENFIELD CO., INC.

Figure 14. A letter of instructions accompanying a draft forwarded by a foreign shipper to an American bank.

The bulk of foreign trade is handled with negotiable documents, because the use of such instruments insures adequate protection for the banks that finance the transactions and facilitates all financial operations relating to the transactions.

Certain formalities connected with drawing and indorsing documents may appear to be nonessential to the American manufacturer, but when he ships to a foreign market, his papers pass thru many hands and a slight omission may cause the shipment to be held up to await correction of the error. And delay in delivery is nearly always serious in business transactions between countries.

When the seller's bank at the American seaboard is holding a bill of lading or warehouse receipt as security for an acceptance, it must relinquish possession of it for sufficient time to allow the document to be exchanged for an ocean bill of lading. The bank engages the services of a forwarding agent for this purpose; or, in certain cases, it may accept from the exporter a trust receipt which grants the powers necessary to the protection of the bank's interests during the interval.

A thru export bill of lading can be used for carload lots when the exporter at an inland point wishes to bill his goods from the original point of shipment to the foreign destination, either a port or a point inland. It can cover shipment by rail or water to the port of export, ocean shipment, and shipment from the foreign port of entry to inland destination.

Commercial Drafts. The commonest form used in financing foreign trade is a commercial draft similar to the ordinary domestic draft. It is drawn in the currency specified in the terms of sale. These drafts are used largely when mutual confidence between buyer and seller has been well established.

Commercial drafts drawn without shipping documents attached are known as "clean" drafts; while those with

shipping documents attached are known as "documentary" drafts. These drafts when drawn upon banks or well-known and responsible business houses (with documents attached if documentary drafts) open to the exporter various possibilities for banking advances and discounts by the use of which he is able to realize, fully or in part, on the sale of his goods as they are shipped. If the drawer and drawee are not well known, however, the drawer may give the draft to a bank to send on for collection, and not receive any money until the draft is paid and the money forwarded to his bank.

An export credit may be opened in a foreign currency. The pound sterling is most commonly employed because of the exceptionally good facilities afforded by London banks in handling bills of exchange and foreign credits.

Future Contracts. Suppose a buyer in England has arranged for his bankers to accept the draft of an American exporter made out in pounds sterling, with documents attached. The American exporter, upon closing the contract of sale by which goods are to be shipped at a future time, can arrange with an American bank which deals in foreign exchange for the sale of his sterling draft under what is known as a "future contract." This enables him to establish a rate at which he will receive dollars for his sterling draft when shipment is made. He can draw, on the American bank arranging the credit, a domestic draft in dollars for the equivalent of the sterling draft figured at the rate fixed in the future contract. When, later on, the dollar draft, accompanied by the sterling draft with documents attached, is presented for payment to the American bank, the dollar draft is paid and retired and the sterling draft is forwarded to a London correspondent bank for collection.

Future contracts are made primarily to protect a buyer or seller against losses in exchange thru fluctuations in the exchange rate between the time when the merchant sells or buys the goods and the time when payment is

made. We have already seen how the seller of merchandise can protect himself between the time he closes the deal and the time of shipment. For the buyer the process is similar. A merchant in this country may be about to purchase merchandise in England and the price is quoted in pounds sterling. At the time the sale of merchandise is made the buyer knows what the cost is in dollars by translating the sterling into dollars at the current rate of exchange. But if shipment is not to be made from abroad for two months and payment is delayed accordingly, he can make a contract to protect himself against a fluctuation in the rate of exchange. He makes a future contract—a contract for the future delivery of pounds sterling at a specified rate. He can then purchase his goods and know that, at a given time in the future, pounds sterling will be delivered to him by the bank at the contract rate, so the cost of the merchandise will not be affected by a fluctuation in the exchange rate.

The bank does not assume the risk that the merchant would ordinarily assume, because contracts to sell are offset by contracts to buy, and the bank merely acts as an intermediary between the buyers and sellers of exchange; the bank undertakes only those contracts which can be immediately covered by offsetting sales or purchases.

Instructions with Drafts. When a draft is marked with the letters D/A, it signifies that the documents are to be delivered to the drawee upon acceptance; in the case of a D/P draft, the papers are to be withheld until payment is made.

As already stated, in dealing with foreign houses of high standing, documents are usually deliverable against acceptance. But it should be indicated plainly on each draft which method is intended, so that the foreign bank may be in possession of definite instructions when presenting the draft. A letter of instruction (Figure 13) usually accompanies the collection, the terms of which must be strictly complied with.

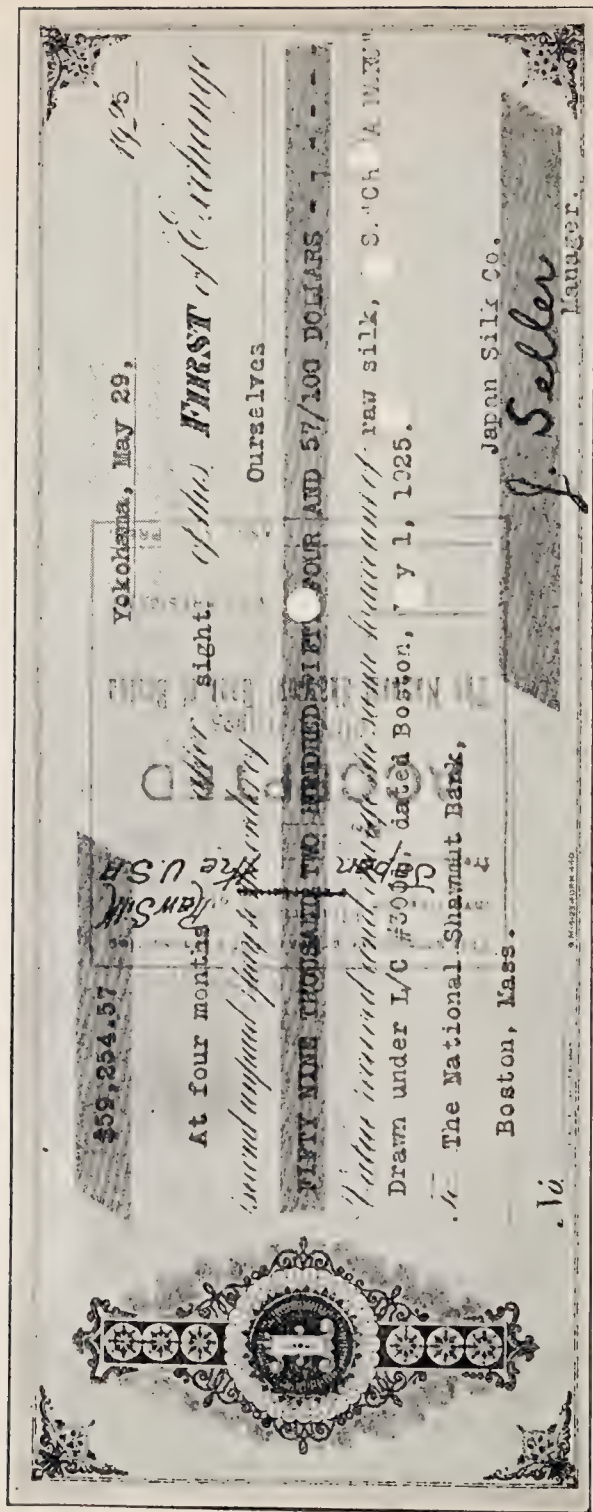


Figure 15. A time draft drawn by a foreign firm under the terms of a dollar letter of credit issued by the American importer's bank. Notice that it is called a "First of Exchange." The "Second of Exchange" is a duplicate and is dispatched by separate mail. The one reaching the drawee bank first is accepted and the other thereupon becomes void.

When an exporter prepares his draft and other documents, he may send them for collection directly to a bank at the point where his customer is located or deliver them to his own bank or to one in a central city for forwarding abroad for the same purpose. In none of these ways does he realize cash for his goods until the return from the foreign bank of the advice of payment. Since only a few of the largest exporters have the financial resources required in doing business on this basis, such collections are few as compared with negotiable drafts covering export shipments.

When a draft is forwarded for collection, the seller should be careful to give explicit instructions so that persons handling the documents may know what action to take in any contingency that may arise. It is necessary, therefore—

1. To indicate whether the draft is drawn D/A or D/P.
2. To state whether, if the former, the item should be held for collection at maturity or returned.
3. To name the rate of discount to be allowed for payment before maturity.
4. To designate a person to be notified in case of nonacceptance or nonpayment, or other contingencies.
5. To specify what action should be taken upon nonacceptance or nonpayment; for example, whether protest is desired and whether in that event, the documents should be turned over to an agent of the shipper.
6. To arrange for notification by cable when delay would cause serious loss. These directions are highly important, especially in the case of perishable goods.

Sometimes such instructions are incorporated on stubs or slips which are easily detached from the drafts. However, this practice is subject to inconveniences, because no record of the directions is left with the banks connected with the earlier stages of handling the documents. This obstacle may be obviated by embodying the instructions in a letter of advice accompanying the draft. Protest for nonpayment should be requested in every case in connection with time drafts D/A, and in some

cases, depending on circumstances, in connection with sight drafts.

Very often the drawee of a time draft will want to pay it before it is due. For this reason, not only should the rate of interest be known, but also the rate of discount the drawee is to receive by paying before maturity.

How Banks Handle Foreign Drafts. Where the exporter draws a draft on a foreign bank or importer and wishes to obtain cash in advance of date of payment, he usually takes his draft with a complete set of shipping documents to a bank and negotiates them for cash. The shipper indorses the draft and other papers in blank, and the bank forwards them to its correspondent in the place where the foreign bank or importer is situated; or, if it has no such correspondent, to a bank that has one. As a rule, American banks do not like to discount bills running over three months' sight. Where goods are sold on longer terms, the drafts may be sent forward for acceptance and return. The shipper then may hold them, to be negotiated about three months before their maturity.

Right here it is worth while to consider the difference between negotiating a draft and handling it in some other way.

When a foreign importer places cash or credit at the disposal of an American bank, and when the American bank, complying with the instruction it receives, pays against documents delivered by the exporter, the transaction is not a purchase on the part of the bank referred to. Prior to the transfer, the funds belonged to the importer. Similarly, in handling a draft for collection, the American bank makes no payment to the exporter until advised that the sum involved has been realized in the buyer's market. When a bank in the United States negotiates a foreign draft, it loans its own money to the shipper on the security of the latter's indorsement and of the value of the goods, title to which it holds in the shipping documents. The bank relies upon its own judgment in deter-

mining the sufficiency of the papers, and forwards them with the necessary instructions to its correspondent abroad for collection.

Who Shall Pay the Interest Charges? The question of who is to pay the interest charges is one that always should be settled between the buyer and seller before the order is executed. One must consider the number of days necessary for mail to reach the buyer, and to return, and, in case of a time draft, the period the item has to run. It is customary to instruct a foreign bank to collect interest at a designated rate. When this is done, the request usually appears on the face of the draft in a simple form.

Local Customs. A careful study must be made of the different methods of making payments and of the customary methods in use in different countries. Many houses have lost considerable Australian trade in the past by demanding cash, whereas the Australian buyer prefers a draft in which a clause is inserted stating that he will pay interest, exchange, and English and Colonial revenue stamps. As a draft drawn in such a way can be discounted for the amount of its face, it is really the equivalent of a cash payment.

It is also important to know the local customs regarding long-time as against short-time payments. Thus dealers in Central America usually require long-time credit. This is because in many cases they have to pay high rates of interest if they borrow at home to make cash payments, and also because buyers in these countries depend largely on the returns from two or three crops in making payments.

Local custom, unless strictly followed, may be the cause of serious handicaps in financing foreign transactions.

Such are the main points of practical procedure in financing exports and imports. We still have to consider, briefly, the matter of foreign exchange.

FINANCING EXPORTS AND IMPORTS

Part II

FOREIGN EXCHANGE

THE rate of foreign exchange—the rate at which the money of one country is exchanged into the money of another country—varies with—

1. The relative value of the metal in the standard coins.
2. The supply of and demand for bills of exchange.
3. The appraised value of the paper currency of the countries involved.

Since all of these factors are constantly operating, and since small or large fluctuations are occurring from day to day, it is important that the business man engaging in foreign trade should have a clear understanding of the basic principles of foreign exchange; for—

So far as is possible, foreign-trade transactions should be protected from losses due to fluctuations in the rate of exchange.

The fundamental causes of changes in the rates of foreign exchange were covered in Executive Manual 4. Let us here review and enlarge our understanding of this subject.

Relative Value of Standard Coins as Bullion. A coin which represents the standard monetary unit of a country contains a certain amount of precious metal, usually gold, of a definite fineness. That is, each coin contains a definite number of grains of the metal mixed with a certain amount of alloy, put in to make the coin more durable.

Thus the value of the gold dollar as bullion, in terms of gold francs, naturally depends on the amount of gold it contains compared with that in a franc. The dollar contains about five times as much gold as a franc, and therefore the dollar is normally worth approximately five

francs. A gold franc piece, if it were coined, would in fact be worth 19.3 cents in gold dollars. Both the gold dollar and the gold franc are "ideal" coins; that is, they are not minted, but are standards by which the metal content of gold coins is compared.

The actual value in our money of the pure metal contained in the coins representing the units of money in another country is the "par of exchange" between the United States and that country.

Thus the par of exchange of the franc in terms of dollars is 19.3 cents, while the par of exchange of the dollar in terms of francs is 5.18 francs. It is this par of exchange around which, under normal conditions, the rate of exchange tends to fluctuate.

Some countries have a monetary standard other than gold. The standard unit instead of being gold of a certain weight and fineness may be silver of a certain weight and fineness. There is no fixed ratio of value between coins of a gold-standard and coins of a silver-standard country. The conditions of supply of and demand for each metal vary from time to time, and the relative values of metals are therefore not fixed.

Supply and Demand of Bills of Exchange. Exchange rates are usually quoted on cable transactions, sight drafts, and time drafts. The price of exchange varies in response to the law of supply and demand, as explained in Executive Manual 4, and foreign-trade transactions cause changes in the supply-demand relationship of exchange.

In the fall of the year, the United States may ship a large amount of grain to England while there is no increase in our imports from England, so that the balance of trade is in favor of the United States; that is, our exports to England exceed our imports from that country. This grain must be paid for, and consequently many drafts will be drawn on English houses while drafts for a smaller aggregate amount will be drawn by English

houses on business concerns in the United States. Some of these will be time drafts and others will be sight drafts, and in some cases the drawing on the different houses will be done by cable.

But the English houses will have to pay these drafts as they fall due. They may do this by shipping gold to pay for them, by drawing checks against deposits or credits in the United States, or by buying up drafts on American business houses and using these to offset the claims against them. This method of offsetting draft against draft takes care of a large portion of the settlements. In this case it means that there will be a big demand for drafts on houses in the United States and consequently that their price will go up. In other words, dollars will be at a premium and pounds sterling at a discount.

But the demand will not be the same for all classes of exchange. On the day we are discussing, there may be an urgent demand for immediate payments. This will increase the premium on cables above that on time drafts, and so on.

Now, it may be that, in the winter, exports from England to the United States will increase, and exports from the United States to that country will fall off. This will tend to reverse the situation—the price of sterling will go up and the price of dollars will go down. If the reversal in trade balance is carried far enough, the pound may eventually be at a premium and the dollar at a discount.

Under these conditions there will be a greater demand for sterling and less demand for dollars. But this may be at the time when time drafts of American houses on English houses as a result of the fall transactions mature. This continual changing in the supply and demand relationships of exchanges causes fluctuations in the rates of exchange.

If at any time the premium on drafts on this country should become excessive, it may become cheaper, under

normal conditions, for the English to ship over gold with which to pay.

When the exchange on a foreign country rises above the par of exchange plus cost of shipping gold, it has reached a point where it is cheaper to pay in gold than to buy commercial paper on that country.

Financial Status of a Country. The third factor mentioned as affecting the rate of exchange operates under abnormal conditions where a country is unable to make gold payments (if gold is the standard monetary unit) on its obligations. These obligations may rise out of borrowing (Government bond or note issues) or out of the issue of currency to serve as a circulating medium. Thus the financial standing of the United States has been high for years, because the American treasury has been able to pay in gold, on demand, all current and maturing obligations.

During and after the World War, it became impossible for many European nations to pay their obligations in gold—due to depleted supplies of gold or to inflated currency. The value of their currencies dropped to very low levels. Their financial status was impaired to such a degree that bills of exchange drawn in terms of these currencies were appraised at a discount far below the mint par of exchange.

As two outstanding examples we may take France and Germany. The gold reserves of both countries were seriously depleted by shipments of bullion to other countries. On top of this, both governments increased their indebtedness far in excess of their ability to pay in gold. The French nation resorted to large government borrowings; the German government issued large volumes of paper currency. In consequence, the circulating currency of each country became greatly depreciated in terms of gold; and the German mark (the pre-War standard gold coin) finally became all but valueless.

The Exporter's Attitude toward Exchange. The Ameri-

can exporter is not directly interested in the amount of goods or services that can be bought in terms of a foreign currency, since his main concern is to convert sums of this currency into American dollars. Yet he must not lose sight of the effect of a country's balance of trade on the exchange value of its currency. If that balance of trade promises to be favorable over a long period of years, the cumulative effect is likely to have an important bearing on the ratio of the gold reserve to the nation's debt. As the ratio rises, the country's financial status is improved, and if the ratio eventually becomes high enough, the country may be able to bring its depreciated currency to par by resuming gold payments on all its obligations (obligations, of course, include paper money issued by the government).

A favorable balance of trade is created by the ability of a whole nation to produce and market more in goods or services than it consumes. The excess—or, as it is commonly called, the balance of trade—tends to be paid for in gold. This incoming gold becomes a strengthening factor in the nation's financial status. It was thus, broadly speaking, that the British government was able to bring sterling back to par in 1925. The British built up a favorable balance of trade, accumulated gold, and convinced other nations of their willingness and ability to continue the policy. They thus gained the co-operation of others who were able and willing to extend long-time credits, which, together with the gold reserve already built up, enabled the British treasury to resume gold payments on its obligations when demanded.

All these factors and conditions—the mint par of exchange, the balance of trade, the cost of transporting gold, the stability of government, etc.—have an effect on the rate of exchange in every situation. They are always existent and interacting.

If instead of France or England or Germany, we considered a country which is on a silver basis, the same things would hold true except for the additional element

injected thru the fluctuations in the relative values of gold and silver.

Arbitrage. It is sometimes cheaper to secure exchange thru a third country rather than directly from the one involved. Let us suppose that at this instant Canada and the United States are exporting to France, France to Holland, and Holland to Canada and the United States. There will therefore be a demand in France for drafts on Canada and the United States, in Holland for drafts on France, and in Canada and the United States for drafts on Holland. In North America the florin (the standard coin of Holland) will tend to be high while francs will tend to be cheap, and in France florins will tend to be cheap and dollars high. The North American, then, by buying cheap francs and using these to buy florins thru France, can offset the price of florins in North America. This method of indirect exchange is called arbitrage. It involves a certain expense in the way of additional brokers' fees and, in some cases, of revenue stamps. The method need not be confined to three countries only, but may be operated thru several.

Arbitrage is practiced nearly altogether by specialists who constantly buy or sell foreign exchange wherever an advantage can be gained—and their activity tends to prevent any marked discrepancies in values between the various foreign-exchange markets of the world.

To understand all the complex mechanism and factors involved in foreign trade is a challenge to the business man directly active in foreign trade. But he will be well repaid by making a special study of the causes of changes in the rates of foreign exchange, with a view toward developing ability to anticipate those changes. A business concern that sells or buys extensively abroad can finance its operations better by having someone in the organization who understands not only the right routine to be followed in foreign shipments, but also the principles involved in the operation of the factors that deter-

mine rates of exchange, including a thoro understanding of the law of supply and demand, as presented in an earlier part of this training service.

* * * * *

In the next executive manual we shall take up the important question of meeting the financial needs created by the growth of a business. As output and sales are increased, more money is needed—with which to provide additional facilities, to pay more salaries and wages, to carry larger inventories, to finance larger volumes of receivables. To know the financial demands of expansion and how to meet them is perhaps the most essential requirement looked for in a financial manager. Before proceeding to Executive Manual 48, however, strengthen your knowledge of financing exports and imports by handling the following check-up and Executive Problem 47.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. Is a more thoro understanding between buyer and seller necessary in a foreign transaction than in a domestic transaction?		
2. Is there chance of misunderstanding in a quotation made to a buyer in Cuba: F.O.B. New York? In a quotation: C.I.F. Havana? In a quotation: F.A.S. Philadelphia?		
3. Is there chance of misunderstanding in a quotation: C.I.F.C.I. Singapore?		
4. Do banks play an important part in financing foreign transactions in which buyers pay cash with orders?		
5. Would you consider it feasible for a large textile mill in this country to sell cotton hosiery to an old, highly rated English mercantile concern on an open-account basis?		
6. Does the burden of financing an export shipment fall on the seller in the instance of a confirmed order?		
7. An American house imports large quantities of matches from Norway. With one Norwegian manufacturer it transacts its business on the basis of letters of credit issued, thru its New York bank and the New York bank's London correspondent, by the London bank's correspondent in Christiania. Would you expect the letters of credit to be issued in Dollars? ☐ Pounds? ☐ Kronen? ☐ Would you expect the drafts to be drawn on the New York bank? ☐ London bank? ☐ Christiania bank? ☐ Would you expect the Norwegian exporter to prefer the letters of credit to be— Revocable? ☐ or Irrevocable? ☐		

	Check	
	Yes	No
8. The Dearborn Flour Mills, Inc., has sold a shipment of flour to an importer at Port Lima, Costa Rica. The terms call for payment by draft, drawn at 60 days' sight, on the importer. Would it be more to the advantage of the millers to have the Costa Rican importer arrange with a New York bank for a letter of credit authorizing a draft drawn on the New York bank?		
9. The Halloran Packing Company, of Chicago, has an inquiry from a French importer regarding a substantial shipment of dry salt-cured meats. If the packing company arranges to accept payment in the form of a 30 days' sight draft drawn on the French buyer, will its quoted selling price likely be lower than if it asks for payment in the form of a bank acceptance drawn in dollars on a New York bank?		
10. Local banks in Colombia, most of which have connections in the United States, furnish adequate facilities for the collection of drafts drawn on Colombian merchants in all the commercial centers. The local interest rate is very high, being from 10 to 12 per cent. Is it to the advantage of the Colombian importer to get the foreign manufacturer to carry him rather than the local banks?		
11. If you were making a shipment of merchandise to a buyer in Bogota, Colombia, would you consider it necessary to have it understood whether your quoted prices included Colombian consular fees?		
12. Are the seller's interests under a draft drawn on the foreign importer, D/P, more strongly protected than under a draft drawn D/A?		
13. If you were exporting goods to Italy under a letter-of-credit arrangement, would you prefer to have the draft drawn in sterling, rather than in lire?		
14. The par of exchange of the dollar is supported by millions of dollars of reserve gold held in the United States. Does this excess gold also act to prevent fluctuations of dollar exchange above par?		

Executive Problem 47

FINANCING EXPORT SHIPMENTS

Handling the Credit and Financial Phases of Foreign Business

UNDER THE LASALLE PROBLEM METHOD



THE marked developments in international commerce, especially during the last decade, have caused American manufacturers and merchants to realize the necessity of studying intensively the methods of financing transactions with foreign peoples. For profitable commercial intercourse with foreign nations can be successfully promoted only when the parties to transactions have a practical understanding of the means by which payment is effected. A knowledge of foreign financing is coming to be an essential part of the American business man's equipment.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

FINANCING EXPORT SHIPMENTS

"I did not have the least conception of the opportunities for foreign trade until I saw those South American cities myself," were the concluding words of Mr. Higdon's narration of the impressions he had gained on his around-South-America trip.

Mr. Higdon had, just a year ago, retired from the presidency of the Higdon Art Glass Company—the company which he had helped to found, and which had grown under his management until it stood fifth in its industry from the standpoint of sales volume.

Now that he had passed the responsibility of day-to-day management on to his younger associates, Mr. Higdon had found time to take what had been planned as a "pleasure trip, purely and simply." But his interest in glassware led him at every point in his tour to inquire regarding such marketing factors as demand, prices, specifications, and the expressed preferences of the trade.

And he had come back an enthusiastic advocate of a "foreign department" for the Higdon Art Glass Company.

He found in the cities he had visited that there was already a substantial demand for glassware such as his company manufactured for equipping electric fixtures, and that this demand was sure to increase. He believed also that such goods were not likely to be manufactured locally. He found a preference for goods manufactured in the United States, and the belief that their quality was superior. He found also that the rate of exchange was favorable and would be likely to continue such, since imports to the United States from these countries were large.

Mr. Higdon's enthusiasm left his son George, the sales manager of the company, unmoved. He objected that, "When we've hardly scratched the surface of our domes-

tic market, why should we go to all the trouble of working up a foreign trade?" Mr. Higdon, Sr., was ready for him. He pointed out the advantage of diversification of market. For example, part of their glass went to jobbers who distributed it thruout America's "wheat country." When the wheat crop was a failure, these jobbers reported "hard times," and the Higdon business suffered. But the failure of a crop here meant high prices for wheat in the Argentine, with corresponding prosperity.

Mr. Higdon continued by pointing out the advantages of the alternations in seasons between the Northern and Southern hemispheres. Buying seasons there corresponded with dull seasons here, so that when manufacturing to meet both demands, the production would run on a smooth schedule.

Finally, he pointed out that it took time to get a toe hold on this rapidly growing foreign demand. While competition was comparatively small there to-day, it was sure to increase, and the beginning should be made now.

Robert, his other son, was treasurer of the company. He was willing to admit the sales and production advantages his father pictured, but asked whether these were not offset by the disadvantage of "extremely long-time credit," and the difficulty of conducting business with foreigners. To this the elder Mr. Higdon made the astonishing reply that his rather careful investigation of foreign-trade conditions had persuaded him that credit losses could easily be kept within one-fourth of 1 per cent.

He said further that this foreign business had appealed to him particularly because it was so attractive from the standpoint of financing. A substantial increase in business could be handled by manufacturing for foreign trade during the slack season, and all without the expenditure of one penny for additional plant investment.

Finally, the senior Mr. Higdon declared it to be his belief that the turnover of working capital would prove to be higher on their foreign trade than on their domestic.

When Robert demurred to this, his father asked him to investigate this carefully for himself. In this investigation you will take a hand and will assist in determining what will be the financial advantages and disadvantages to the Higdon Company if it enters the foreign field.

SOME FACTS REGARDING THIS COMPANY'S BUSINESS

The Higdon Art Glass Company sells exclusively to jobbers. Its salesmen assist the jobbers in distributing the line by calling on architects and many of the jobbers' customers. The selling expense

runs about 9 per cent of sales, and $1\frac{1}{2}$ per cent additional is spent in the preparation of artistic catalogs, booklets, etc.

The terms are net sixty days with a discount of 2 per cent for cash in ten days. The average collection period is forty-three days.

Should the company decide to solicit foreign trade, three general methods are possible. First, it can solicit export business from the export houses located in this country to whom foreign importers send their orders. Such business is practically the same as domestic business, since the export houses pay for the goods on the regular terms, the only difference being that special care must be taken to meet export requirements regarding packing, etc. While this method will put a small amount of goods into foreign lands, it cannot fairly be termed a foreign-marketing plan, since no effort is made to instruct the foreign dealers and consumers regarding the goods so as to create a foreign demand for them.

Secondly, Mr. Higdon has been referred by his bank to a reliable export distributing house. Its representative has investigated the company's line very carefully, and has made a proposal under which his firm will undertake to market it in South America.

This organization has representatives (importers or agents) in all the larger South American cities. The export distributing house will undertake to provide these representatives with selling information and to quote them prices C.I.F. Buenos Aires (or whatever the nearest port may be). For this service the export firm proposes that it receive a price 10 per cent less than the regular jobbing price, and also the regular 2 per cent discount for cash in ten days—a discount which it never fails to take. The only expense for the Higdon Company will be the printing of a special Spanish edition of its catalog and the extra cost of export crating for such goods as are sold. It is anticipated that it would take about a year before sales of any volume could be secured under this plan. The export distributing house therefore asks that it be considered the exclusive representative of the Higdon Company in South America, for a three-year period.

A third method is for the Higdon Company to develop a foreign organization of its own. This requires either that it hire someone who is acquainted with foreign-trade usages, or that one of its present executives become an expert in it. It requires also that the company send a sales representative to South America. Under this plan, so Mr. Higdon is advised, at least two years should be allowed before the department can be expected to pay its own way.

Let us now turn to the working papers and analyze these plans from the standpoint of sales expense and financing cost, to determine whether it is likely to prove profitable for this company to go after foreign business.

BUSINESS MANAGEMENT

FINANCING FOR EXPAN- SION—Being Executive Manual 48, on Financing a Business, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
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FINANCING FOR EXPANSION

Part I

KEEPING FINANCE IN STEP WITH GROWTH

THE owners of every business like to see their enterprise grow. The growth of a business may be allowed to take its normal course or it may be retarded or accelerated by its management; for—

The management of a business has a measure of discretionary power in shaping the growth of that business.

We often speak of the “natural growth” of a business, but there is really no such thing apart from the influence of management. The plans, policies, ideals, and ideas of management, put into action, are constantly molding the form and progress of the enterprise. Thus growth and current management of a business are inseparable. It is equally true that—

Financing for expansion is inseparably bound up with the problems of current and permanent financing.

Planning Ahead for Expansion. Providing money for the purchase of supplies, raw materials, parts, merchandise; for the payment of taxes, insurance, wages and salaries, and all operating expenses, requires planning ahead, based upon facts as to costs, volume, and markets; also probable collections. We have seen that ability to plan ahead is a fundamental factor in financing. It is this factor, greatly intensified, that plays the most important part in financing for expansion. In this last executive manual on financing, therefore, we are in reality not dealing with a new subject, but are studying another aspect of planning ahead. Many of the same principles apply in financing for expansion as in financing the

start of a new enterprise and in financing its current operations.

Providing Permanent Capital for Expansion. First, let us examine the similarity between planning a new enterprise and planning expansion in a going concern.

In starting a new business the owners need to estimate carefully the amount of capital required, including not only capital for investment in fixed assets, but also working capital to be invested in inventories and in financing credit sales if sales are to be made on credit. This capital consists of money and other assets contributed by the owners; and much of it may be borrowed on long-term loans. All of which is also largely true of the business that plans definite expansion.

Capital should be large enough to cover all investments in fixed assets and to provide funds for carrying on the profitable operation of the business.

Observance of that elementary principle of efficient financing would have prevented many failures among new enterprises and among going concerns in process of expansion. Many new concerns and some going businesses in process of expansion underestimate their capital requirements. They either do not capitalize high enough and sell enough stock or borrow as heavily as they could and should in order to avoid a shortage of capital later on.

Current Operations and Capital Requirements. It is a serious mistake to try to finance too large a portion of current operations with short-term loans (from banks, suppliers, or others). This mistake is likely to be made when the owners of a business see fixed assets as a permanent requirement which must be financed out of owned capital or long-term borrowing, but do not see clearly that current operations also require a certain amount of permanent capital.

Just how much permanent capital should be provided out of owned funds or long-time borrowing to meet

operating capital requirements is difficult to determine in many cases; but it is better to err on the side of having somewhat too much capital rather than too little.

Provide enough permanent capital to make sure that current operations will be adequately financed in sufficient volume to make the business profitable.

A certain minimum of operations is as necessary to the life of a business as are the fixed assets. Where facilities are being added for increased operations, sufficient permanent capital must be made available—

1. For purchasing new equipment.
2. For financing the additional volume of business.

Financing Expansion from Within. There is a close similarity between financing for expansion and current (day-to-day) financing. Except where a quite ambitious program of expansion is contemplated, involving the raising of a considerable sum outside of the business (as thru the sale of stock or bonds), a reasonable degree of growth may be financed from within by the conservative use of surplus earnings. Gradual expansion in this way—where efficient day-to-day financing is practiced in accordance with the sound principles brought out particularly in Executive Manuals 45 and 46—is possible without as much risk as is incurred by a more pretentious program, such as that of doubling output within a short space of time.

Gradual expansion, adequately financed out of current profits, is the ideal method of developing a business.

A close watch on current income and outgo, avoidance of unprofitable borrowing, keeping all expenses down to a minimum consistent with true economy—such measures will, with the right functioning of the production, administrative, and sales activities, result in sufficient profits so that some of them may be turned back into the business in the form of additional resources to be used in gradually extending operations.

It is in failing to keep a close rein on all activities of the business that management may fail to meet the added financial stress placed on it by expansion. A growing business absorbs capital faster than expected, in many cases. It is easy to underestimate the operating and developing capital required for expansion; it is easy to make a business grow too fast, out of zeal to see it grow.

Take the case of George Westinghouse, who founded and established the Westinghouse Electric & Manufacturing Company thru his genius as an inventor, organizer, and salesman. He was a brilliant success in business—with the exception of financing. He seemed to lack the faculty of providing adequate capital for the rapid growth of the business. As a result of this lack of foresight in financing, he was finally compelled to relinquish control of the management of this big business, which he had so ably established.

In the growth of any business, the two principal factors to be considered are, first, visualizing the future trend of the business—estimating accurately the progressive demand for the product or service rendered, the supply of labor and raw material needed, and so on; second, determining how expansion will affect the financial needs of the enterprise.

There must be careful forecasting of financial requirements.

Seeing Future Financial Needs. The need for planning ahead has been emphasized in other executive manuals of this training service. If funds are limited, this need is all the more pressing.

Every business man must develop and value correctly the forward-looking vision that is necessary in keeping finances in step with business growth.

One Eastern manufacturer, whose sales grew out of all proportion to his financial resources, had several narrow escapes from failure. At one time, right in the midst of his most active selling season, he was without sufficient

money to meet his pay roll. He had not established a solid bank credit, and he was behind in his payments to his suppliers. In fact, he had no real plan for financing his business. He was a good manufacturer, but a poor manager of finance. However, this man was fortunate in having friends who knew of his integrity, his ability as a manufacturer, and the great demand for his product. From them he obtained enough to tide his business over the crisis. At another time he bridged a critical period by persuading his suppliers to give him much longer time than customary in which to pay them.

Finally this manufacturer saw the necessity of balancing the growth of the business with his resources, and began to plan ahead accordingly. It meant, temporarily, a slower rate of expansion, but thereafter the development of his business was not attended by the occasional crises which had formerly placed his business at times on the brink of bankruptcy.

How can we plan ahead effectively? Altho each business is, in some particulars, different from others, there are certain general methods and procedures which tend to make future financing less hazardous in any business. These we should carefully consider.

Avoiding Too Rapid Expansion. First of all, in planning ahead, we should be very careful not to plan for too great or too fast expansion. Carried away by a chance to make money fast, many have undertaken a greater volume of sales and of production than could be handled with the available working capital. Then, suddenly, they were faced with the alternatives of obtaining loans at very high cost or of offending and losing a number of valuable customers—or, in some cases, failure of the business.

The late James J. Hill, known as the "Empire Builder," saw the wonderful possibilities of extending thru the Northwest a small railroad spur running out of Minneapolis and St. Paul. This was the beginning of the building of the Great Northern Railway system. Mr. Hill, at

the same time, laid the foundation for building many towns and cities along the way in this rich but undeveloped country. He thereby helped to create a growing demand for the transportation facilities of the Great Northern. He knew that his "sales" had to grow fast in order to make the new road pay. His planning ahead provided for progress that was not too rapid in relation to his financial resources.

Spectacular growth is very often of the mushroom variety. It does not last. Nearly always, a conservatively managed business goes ahead, not so rapidly, but safely and surely within the confines of its financial resources. Of course, there are cases where a business has been started on a "shoestring" and has grown rapidly; but in most cases such enterprises soon fall by the wayside or pass into the hands of others thru financial reorganization.

Management should never attempt to force the growth of a business faster than is consistent with stability of sales and amplitude of working capital for financing expanded operations.

Expansion of sales, and therefore of production, brings with it the necessity of maintaining the higher sales volume in order to avoid the wastes that would accrue were sales to fall and the business to carry on at only a fraction of its producing capacity.

Adjusting the Marketing Program to Finances. Growth is often obtained by developing markets more extensively, using advertising as an aid in spreading the distribution of the product or service. In securing broader distribution, it is necessary to be very careful that financial resources for pushing on to success are available. It may require more working capital than anticipated to carry an advertising campaign thru to the point of effectiveness; and it often requires considerable money to take full advantage of the advertising as well. Ambitious marketing campaigns should not be attempted until there

is assurance of all the necessary funds to carry them thru to success, and to provide capital for handling the increased sales and production.

In every case, the extent of market development should be held well within the ability to supply proper financial support for the campaign, including financial resources sufficient to handle the business obtained.

Proper Location and Leases. Location and leases also may prove vital factors in financing expansion. We have seen that location is particularly important in the case of certain retail stores. It is equally important for the factory, the bank, and many other lines of business—from the standpoints of labor supply, sources of raw material, proximity of available markets, etc.

No business can afford to overlook a study of its location problem—its convenience for workers, for customers, for transportation, and for supplies. The financial success of a business has often depended upon this one matter of location more than any other factor. There are many cases wherein a poor location has been the main factor in the failure of an otherwise well-managed business.

Attention has also been called to the important part that leaseholds play in relation to probable business growth. A provisional clause stipulating renewal of the lease at a definite figure is usually a wise precaution. Also, the choice of a location, where expansion of space to be occupied at a future time is considered, has often proved to be wise foresight, for there is usually considerable advantage in retaining the same location for a long time.

The continued occupancy of a favorable location has a most important bearing on the possibilities of future growth; it should always be considered in making plans for expansion.

A Grasp of the Labor Problem. In order to make finances

keep pace with growth, a clear grasp is also needed of the labor problem in all of its ramifications—salary and wage rates, and possible changes and demands of all sorts. Provisions for possible strikes, for demands for increased wages, and many other contingencies have to be considered in connection with plans for future developments and growth. Failure to iron out labor troubles has caused financial ruin to many concerns. This problem will be fully treated in a later division of this training service on managing men. How this problem is handled has an important bearing upon successful financing of a business; and expansion of a business cannot be economically promoted when hampered by restrictions growing out of insufficient or inefficient labor or out of difficulties between management and men.

Importance of a Budget. A budget plan is essential in maintaining proper balance between available money and the financial requirements of the business.

A company in the Middle West has a surplus of money during three months every fall. It buys ninety-day commercial paper, from which it receives a fair rate of interest, and gets back the principal in time for its late fall needs. Its budget plays an important part in permitting it to put its surplus cash to work. (What to do with surplus will be covered in the second part of this manual.) A budget which really charts the financial future of a business will show plainly whether expansion can be financed out of present capital and accumulated profits.

No business can take thought of to-day alone, but must plan its future and map out its progress so that its finances will keep pace with its growth.

Determining the Policy as to Expansion. The problem of formulating a policy as to expansion is present in every business organization regardless of what its aims may be. The policy may be that of normal growth, either slow or fast. The management may decide to use a restraining

influence on all tendency to expand; or, as is more usual, management may deliberately plan to accelerate growth at a definite rate.

Many concerns expand without unusual or premeditated effort. They grow without making deliberate plans or effort to grow. Their growth may come from a favorable location, natural advantages, leadership in the field, or from owning a patent on a product that is in growing demand. The market for this product may be so great that sales soon run ahead of initial producing capacity. But such a situation, as in nearly every other case of growth, calls for planning ability that can provide proper adjustment of outgo to income in order to provide funds for growth.

In every case there should be a policy and a plan covering the rate of growth and its proper financing.

Some owners and some managements do not want their concerns to grow in size. They feel that a point has been reached where all operations are well balanced and the organization functions more economically as a unit than it could if it were any larger in size. One well-known executive in the automobile field, whose opinion is widely respected, has always had a very conservative attitude toward expansion. He has what would ordinarily be considered as large-scale production, but does not care further to expand his plant, because he now has ideal balance for economical production of a product of very high quality. His selling expenses are comparatively very low for this industry. But he estimates that to sell double his present output (the volume necessary to maintain his present condition of balanced production) his selling expenses would of necessity be quadrupled.

Usually, however, management is constantly formulating plans for increasing sales—thru additions to the sales force, thru more scientific salesmanship practice, thru the development of new markets, thru the addition of new products, thru improvements in service, etc. Behind

these efforts, of course, is the desire for greater profits. Ordinarily the more business that is transacted, the greater the aggregate profit, due to increased volumes of units sold and to economies which result from large-scale operations. But expansion cannot be followed blindly. A point is eventually reached where profits do not increase proportionately with growing volume. The cost of further increasing sales in a well-worked market may become so high as to reduce profits.

In formulating any plan for expansion, management should strive to determine the point at which the economies of large-scale operations are overbalanced by increased costs.

Production Requirements and Expansion. Sometimes expansion may be necessary to maintain satisfactory sources of supply. Quantity purchases may be essential to low-cost production without which great difficulty might be encountered in meeting competition. Or perhaps a steady flow of the right materials cannot be secured without controlling certain sources of supply. Or it may be more economical to manufacture certain parts than to keep on buying them.

Certain oil-refining companies have acquired oil-producing properties—and certain crude-oil producing companies have acquired refining facilities. Certain automobile manufacturers have gone into iron and coal mining; and a leading automobile manufacturer has purchased a railroad to secure better transportation facilities. Such integration of large industries is one of the outstanding forms of expansion in modern times. A garment manufacturing concern found itself hampered because the suppliers of material drove “hard” bargains and could not be made to guarantee deliveries. Eventually this condition made it necessary for the manufacturing company to acquire a small textile mill in order to be certain of a sufficient supply of material at a satisfactory cost.

Sometimes a concern may expand to acquire better-

ments in the form of more modern quarters, improved equipment, etc., in order to turn out a more finished product. Or it may desire to buy out a competitor, or to consolidate for economy's sake.

Economies of production and other advantages are often gained by large-scale expansion of a business.

This kind of expansion naturally calls for the most careful financial plans; it often requires financial reorganization in which new issues of stocks and bonds play a prominent part. This problem of business management will be fully treated in a later section on organization and reorganization.

Determining How to Expand. It is plain that management may have an expansion problem on its hands without having sought it. For that reason management should so arrange its finances as to be prepared for expansion ahead of necessity.

When all cases, both large and small, are included, perhaps more business organizations finance their expansion from their own earnings than in any other way. Some do this because it is the only way they know; others because they are unable to raise capital in other quarters. But it is rarely the case that a concern can expand rapidly by this means.

A manufacturer of jewelry cases had a slow and difficult start of his business. The place of manufacture was far away from his best market; operations were carried out on a small scale and scattered over a wide area. Eventually, after a terrific struggle under great strain, the concern was piloted to a position where its net profits were \$50,000 a year—large enough to take care of purchasing betterments and of financing increased volume. Moreover, the credit standing was now high enough to attract outside capital. But in the beginning, when outside capital was most needed, this business did not have sufficient capital or credit to take advantage of the purchasing and production economies which were

obviously desirable. That experience is not unusual. In the early days of many business concerns, when success looked most doubtful, added capital was most difficult to secure—when it was most sorely needed.

Knowing how to raise additional capital for expansion during the early stages of the growth of a business is exceedingly important. "Knowing how" is, of course, essential to any well-ordered plan of financing the growth of a business.

If the business is an individual proprietorship, should the owner take in a partner, or should he secure a personal loan, or should he sell some of his personal holdings? If a partnership, should the owners take in additional partners, or employ one of the other methods of securing additional capital? If a corporation, should additional stock be sold to present shareholders; should new shareholders be secured; should certain unnecessary assets be sold; or should notes or bonds be issued (secured, perhaps, by a mortgage on the property)? Such are the methods to be considered as an alternative to financing "from within."

Sometimes conditions are such that the only solution to the problem lies in financing from within until such time as earnings become sufficiently large to attract outside capital. However, management should bend every effort to put finances in such shape—as early as possible in the life of a business—that it will have a choice as to methods of financing expansion. For where no choice exists, and where earnings in themselves are not large enough to take care of expansion requirements, the owners must usually share ownership with additional owners—at a disadvantage to themselves.

As we saw in our study of financing a new business, the problem of raising capital from outside sources is directly affected by the extent and kind of risk to be taken by those who supply additional capital. Risk of loss is a vital factor in attracting outside capital. Where

the earnings record of a business is poor, and where additional funds are sorely needed, the risk is often so great as to deter prospective investors or lenders from advancing money without some compensating concession—usually a share in the control of the business, which may carry with it a considerable “slice” of future earnings.

It is one of the prime objectives of efficient management so to arrange finances as to obviate the necessity of surrendering control in the process of expanding.

Thus it is that an individual proprietor or a group of partners will often prefer to borrow rather than to admit others to part ownership. So it is that a corporation will often decide to issue bonds rather than additional voting stock.

Raising Additional Capital for Expansion. When it becomes necessary or desirable to obtain additional capital for expansion, and that capital cannot be readily accumulated in the business, management, in the case of a corporation, must decide whether to issue more stock or to borrow thru notes or bonds, secured or unsecured.

What are the factors that influence this choice?

First is the factor of sharing control and future profits. Will the issuance of additional shares of voting stock jeopardize the control and earnings of the present owners? Perhaps the new stock could be distributed *pro rata* among present stockholders, so that control would not be altered; or perhaps preferred stock could be issued with a definite dividend rate, so that unusually good earnings would still go to the holders of the common stock.

Next is the debt factor. The issuance of additional stock carries with it no obligation to repay the added capital on the part of the corporation, and no indebtedness on which interest must be regularly paid. Even where preferred stock is issued, the corporation assumes no obligation to pay the prescribed dividends except as

earned, and no obligation to retire the outstanding shares.

Thus capital obtained thru issuance of stock is free from fixed charges and definite maturity dates, so that management may plan ahead freely without being forced to provide funds for payments of interest and principal.

This freedom from hampering restrictions is an important consideration, especially when it is remembered that many firms find it difficult to set the maturity dates of their bond or note indebtedness so as to obviate serious difficulties at the time when the principal sum of the indebtedness must be repaid.

This matter of fixing maturity dates on bonds and notes is one that should be given careful attention by management. Large issues should not be allowed to mature too closely together, for then there may be great difficulty in accumulating sufficient funds to retire them—either out of earnings or out of re-funding operations. Witness the straits in which the Chicago, Milwaukee & St. Paul Ry. found itself in 1925, when it faced the maturity of bonds in excess of a hundred millions within a few years' time.

The Effect on Future Profits. Another important factor to consider in deciding whether capital for expansion is to be raised thru the sale of stock or thru the sale of bonds or notes is the effect on future profits. How will future earnings be affected? Will profits to the present owners be greater or less? Ordinarily, of course, bonds or notes offer *greater* security to investors, and for this reason sell at a *lower yield* than the capital stock of a company.

A southern electric power company sought capital a few years ago for enlargement of its generating capacity. Should it issue 5 per cent bonds or should it sell 7 per cent preferred stock? The market was such that

either issue could probably have been floated at par. The company, of course, chose the advantage of saving 2 per cent per annum by issuing bonds rather than stock.

Time is a very important factor to consider. Under prevailing conditions of the securities market, is it better to issue stock or to borrow? Can the class of investors that the company wants to interest be attracted more readily by bonds or by stock? The answers to these questions can be determined only by a careful study of general business conditions. During a period of depression, it is usually very difficult to interest investors in stock issues. The best time for this is just following general trade revival when the earnings outlook in general is such as to inspire confidence in the future. People are then more willing and are even eager to buy shares in growing, prosperous enterprises because of the promise of large future earnings.

It is often possible for management to take advantage of movements of the business cycle by borrowing during periods of lessened trade activity, when interest rates are fairly low, and by retiring these loans when times are more favorable for a stock issue.

Avoiding Common Mistakes in Expanding. Such are the important factors to consider in determining how to finance expansion when capital is to be raised outside the business. Too much thought cannot be given to this question of how to finance for expansion. Mistakes are always very costly to present owners. While management may, in time, iron out the difficulties caused by injudicious financing, it cannot recall the profits lost by it. Using the wrong method of securing capital for expansion may prove as harmful as unwise expansion itself, or underestimation of capital requirements. Where a small but prospering concern mortgages its fixed assets to secure a small loan, it often finds itself hampered later on when a much larger sum is sought by long-term borrowing. The small lien may be a big obstacle in floating

a large mortgage loan (either thru bank borrowing or thru the sale of bonds) because of the impaired security.

Great care should be taken in financing the initial stages of expansion not to incur restrictions that will hamper future expansion.

The National Cash Register Company, early in its history, was hard pressed for funds with which to finance its rapidly increasing production and sales activities. Its founder and chief owner, John H. Patterson, was then not an able financial manager. In his anxiety to procure additional capital, he was induced to enter into a very unfavorable agreement with an eastern capitalist, which prevented his company from obtaining funds from other sources later on. It was only thru the services of a keen-minded Boston banker that a broad refinancing program was eventually worked out that prevented Patterson from losing control over the prosperous business that his inventive and sales genius had built up.

Financing That Conforms to General Conditions. The effect of rising or falling prices, of general business activity or recession, must be anticipated to afford management an opportunity to make financial arrangements conform to developing conditions. A blind policy of expansion nearly always leads to difficulties. With even a slight change for the worse in general business conditions, it seems as tho many obligations fall due with preconcerted and accentuated persistency. To foresee such a change and prepare for it are prime functions of financial management.

The effect of a possible change for the worse in general business upon the financial strength of a concern should be fully considered in advance.

An automobile-accessories company, which in a few years increased its capital from a few thousand dollars to several millions, let its expansion policy get ahead of its financial resources to such an extent that a serious business reaction found it unable to meet all of its obli-

gations. Expansion had been based on the size and profitability of present business without consideration of the causes which created the great amount of business and the probable duration of favorable conditions. When prices suddenly declined and sales fell off, this business suffered an operating loss of more than a million dollars in one year, and went into the hands of a receiver.

When to Expand. The business organization which does not carefully plan ahead may think of expansion only when business is booming, when there is a large number of orders on hand, and when operations are cramped for lack of space. At that time it may vote to buy new equipment, to embark on a new construction program, to increase the pay roll, to extend its marketing facilities, and so on.

From our earlier executive manuals on the principles of profitable management we learned that increasing business activity is usually accompanied by rising prices. Expansion during a business boom when prices are high is costly. A paper mill, during the post-War boom, when business was thriving, acquired more timber lands and mapped out an extensive construction program. Large obligations were incurred at high prices. Shortly afterward the bottom suddenly fell out of the paper market, and before one issue of bonds had been sold it was found necessary to raise additional capital.

It is better to expand in anticipation of general thriving business than to wait until a boom is on.

This is particularly true from the standpoint of providing capital. When business in general is sluggish, loaning rates and building costs are lower than at the peak of activity. Not only can permanent capital be provided thru long-time borrowing at a lower rate, but any additions to plant and equipment, to warehouses and other distributing facilities, can be made at a relatively low cost. Even after a period of general rising prosperity has definitely set in, there are many opportunities for

raising capital and making extensions at lower costs than during the peak of prosperity. Thus expansion can be successfully and profitably financed in times of thriving business when it can be ascertained that good conditions will probably last long enough to give the additional investment the opportunity to make adequate returns. (How to forecast the trend of general business conditions was explained in Executive Manual 3.)

A financial manager needs to understand the interplay of economic forces as they affect business conditions, so that he may anticipate changes in the financial condition of his business as affected by changing business conditions. Especially is this ability necessary in determining the financial requirements for putting thru a program of expansion.

Whether expansion is planned thru the use of excess earnings, or thru the issuance of stocks and bonds, or thru some other means, economic conditions will have an important bearing on the success of contemplated operations. Expansion which is based upon scientific gathering, observation, and interpretation of facts and trends is in the long run likely to be most economical and profitable.

FINANCING FOR EXPANSION

Part II

WHAT TO DO WITH SURPLUS

RELATED to the problem of expansion is the problem of what to do with surplus earnings. It is largely thru the influence of surplus earnings that business enterprises derive their natural tendency to grow. We know how important are a favorable earnings record and a sound financial status as factors in attracting capital for expansion. We also know that expansion is often financed out of surplus earnings, without attracting more capital from the outside.

Shall surplus be used to expand operations? Shall it be accumulated for future use in expansion? Or shall it be distributed to the owners of the business? The whole matter of present and future growth may be vitally affected by the answers which management gives to those questions.

What Is Surplus? As explained in a previous executive manual, surplus is the excess value of the assets owned by a business over and above the sum of all its obligations and the capital contributed by the owners. The normal source of surplus is the retention of profits in the business. Surplus may exist in any or all of the different forms of assets—in the form of cash, receivables, materials, equipment, buildings, real estate, etc. It is not necessarily cash, altho all or a great part of it may be in that form.

In accounting practice, surplus is the amount which, when added to the liabilities and capital accounts on the right-hand side of the balance sheet, brings the right-side total into balance with the left, as explained more fully in Part I of Executive Manual 44.

The size of the surplus account is not always indicative of its true value or usefulness. How it originated and the form or forms of assets in which it exists have much to do with its value and usefulness.

How Surplus May Originate. Surplus may originate from the following sources:

1. Profits.
2. Donations.
3. Revaluation of assets.
4. Sale of assets at a profit over book value.
5. Insufficient allowance for depreciation, maintenance, etc.

It is plain that not all these sources of surplus indicate a real increase in asset values. Revaluation of assets—the placing of a higher value upon a firm's property, for example—is, even if bona fide, an easily misunderstood medium for the creation of a surplus. A declaration of dividends on this basis might seriously embarrass the credit of the institution, and be equivalent to declaring dividends out of capital invested. Higher prices of raw materials revalued on a basis of inflated prices may never be actually realized, and equipment values of to-day may be wiped out in a few years by depreciation or obsolescence. Where insufficient allowance is made for depreciation, the surplus account will show up larger than conditions warrant.

Of all the sources of surplus the best is the setting aside, or the investing in the business, of profits.

Where surplus is largely in the form of cash (in which case it may be set off as a surplus fund), it may serve as an important and a ready aid in furthering plans for expansion or in meeting unexpected emergency demands on the treasury. Building up a cash surplus fund really means "business insurance." It provides not only something to fall back on in case of financial stress or unforeseen catastrophe, but also something to keep going on when the course of business does not proceed as expected.

Dividend Policy and the Surplus. The individual proprietor or the owners of a partnership enterprise are usually under no restraint, other than that of sound business policy, in taking profits from the business for their personal use.

In declaring dividends, the directors of a corporation are, however, governed by state laws, by the charter and by-laws, and by any preferred-stock contracts. If there are any back dividends on cumulative preferred stock, they must be taken care of first.

Dividends may be paid—

1. In cash.
2. In scrip.
3. In stock.
4. In property.

Cash dividends may be paid at any time the directors so decide. If the question arises as to whether the company can or should spare the cash, distribution may be made in scrip, by which the corporation issues to its stockholders certificates reciting that they are entitled to privileges therein specified. The rights of a holder of a scrip certificate are defined and limited by the contract expressed therein.

Stock dividends simply transfer accumulated surplus into the capital stock account where it shares in the rights to future dividends. The United States Supreme Court has decided that stock dividends are not taxable as income, since they are simply book adjustments of ownership interests.

Property dividends usually come in the form of securities. During the period of the War, for example, several corporations distributed dividends in the form of Liberty bonds or securities of foreign governments.

Dividends are usually declared out of profits, tho during years of lean profits they are often declared out of

earned surplus which has been previously accumulated

The building up of a surplus fund beyond the needs of operating capital makes possible the declaration of dividends when current profits are too small to permit paying them.

The Value of a Uniform Dividend Policy. Many corporations find it desirable to keep the dividend rate uniform year after year. The maintenance of a steady dividend rate has a tendency to assure—

1. Higher and steadier prices on the outstanding securities of the corporation.
2. Readier sale of new securities.
3. Higher credit standing.

When a corporation has more funds than it needs for regular dividend requirements, it may distribute extra dividends at certain periods. But by allowing a certain portion of the earnings to accumulate, value is added to the assets and confidence in the financial strength of the business is promoted. Or a business may seek to establish itself more firmly in its field of activity by using accumulated surplus in certain kinds of research work, such as market research and good-will advertising, by which it can insure greater stability in sales volume with, consequently, a more even flow of profits.

Reserves for Contingencies. Part of surplus can be set aside or specifically designated as reserves to take care of special or contingent needs, such as losses from bad debts, abnormal losses from declining inventory values, depletion of natural resources, etc.

Where reserves are maintained for special purposes, they should be held in the form of cash or in easily liquidated securities or other property, so that they may be available when the time comes to use them for these purposes.

Uses of Surplus Funds. Where a surplus fund is accu-

mulated, there are two general uses to which it may be put:

1. Outside investment.
2. Investment within the business.

Which of these two uses is better in any case depends largely upon conditions at the time of decision. Unless the surplus can be more profitably invested in the expansion of the business, it should be put into the stocks or bonds of other concerns until enough can be accumulated for a particular purpose. Very often it is best to put surplus earnings back into the business in the form of additional working capital with which to meet needs arising from slower turnovers, higher prices, larger purchases, extended operations, etc.

When earnings steadily exceed capital requirements for profitably carrying on the various activities of the business, and when no immediate expansion of operations is being planned, investment in outside securities can be made to strengthen the credit standing of the concern and at the same time to yield a good return.

If the investments are handled skilfully, with due consideration for safety and marketability, the funds will be available whenever needed for emergency or expansion. Meantime, they draw interest.

Outside Investment of Surplus Funds. Let us first consider the investment of surplus funds in outside securities. Clearly, the chief value of an emergency fund lies in the speed with which it can be turned into cash and applied to the use for which it is needed. This also applies to a fund which is being reserved for future expansion purposes.

Some men are so much interested in promoting the success of the enterprise they have built up that they put back everything they make into the business, but often without due consideration of when to expand, and without provision for definite contingencies. It is obviously

unwise to devote every penny of surplus earnings to business expansion.

When an executive analyzes efficient financing, he readily sees the value of putting some of his extra funds into a cash reserve or into liquid assets, such as Government securities or stocks and bonds of other concerns, so that he may have readily marketable securities to sell or use as collateral for a loan with which to meet any emergency or take any desirable step that requires an unusual amount of cash. He must choose the kind of investment which will be safe, and readily convertible into cash when needed.

Since many executives do not have the time or inclination to make a thoro study of investments, it usually pays to secure the services and counsel of a responsible banker or investment house. However, there are certain fundamental principles of investment which every business man should understand. The several essential and important factors usually considered in the purchase of securities are the following:

1. Safety.
2. Marketability.
3. Yield.
4. Maturity.
5. Diversification.
6. Market conditions.

Safety of Principal. It is seldom the case that surplus is invested in securities in order to obtain the greatest amount of income; rather, the securities are purchased to provide temporary and safe use of surplus funds pending their introduction into the operations of the business. (Otherwise, it is usually best for all concerned to have them distributed as dividends.)

Safety can be found in all the various classes of investments commonly sought by business concerns: stocks, bonds, mortgages, notes, and acceptances. But careful

discrimination is to be used. Individual securities in any one class cannot be said to carry less risk than those in another class. The common stock of one company may carry a lower element of risk than the first-mortgage bonds of another. The unsecured note or the trade acceptance of a highly rated mercantile concern may embody greater security than a real estate mortgage. Yet some classes of securities are, as a whole, much safer than other classes as a whole. Bonds, as a class, for example, are safer than stocks. But there is always the necessity that each individual security be carefully investigated and judged on its own merits.

Perhaps the greatest single factor to consider in judging the safety of a security is the credit standing of the issuer—whether person, association, corporation, or state.

United States bonds constitute a standard by which we judge other investments, principally because they, probably more than any other security, represent our highest conception of safety. But the bonds, and even the stocks, of some of our large, successful, well-managed railroads, public utilities, and other industries offer a wide choice for the conservative investor. (Of course, high-grade stocks are subject to wider fluctuations in market value than high-grade bonds.) Then there are real estate first mortgages, notes, and acceptances. Domestic or foreign bills of exchange drawn on reliable banks or on business houses of high standing offer a medium of short-term investment with a high degree of safety, as a class.

Where management elects to invest surplus funds outside of the business, its first consideration should be for the safety of the principal.

Marketability. While safety is perhaps the most important factor in deciding upon an investment for surplus funds, the nature of the use to which these funds are eventually to be put usually makes ready marketability also imperative. Stock exchanges, banks, stock and bond

brokers, and commercial-paper houses offer broad and active markets for many securities of different kinds. Therefore, before purchasing any particular security, a business man should assure himself that he can find a ready market for it at a fair price. Under forced sale, some securities—those that are not listed on an exchange or have no general market—may have to be sold at a considerable discount from their real value.

Returns on the Investment. One of the main reasons why a business concern invests idle funds in income-producing securities instead of placing the money in the bank is to get a yield higher than the bank would feel justified in paying. Yield also has an important bearing on the price which may be obtained at the time of sale. Therefore, it needs to be considered along with the other factors, but it does not come first in importance. The yield of a security usually varies inversely with the degree of safety and marketability.

Eagerness to make profits on outside investments should not be allowed to warp judgment as to the safety of an investment which promises a very high yield.

Maturity. With the exception of stocks, the various classes of investments previously enumerated have definite maturity dates; that is, a date when the principal falls due and payable.

Maturity, in the case of bonds, notes, mortgages, and bills of exchange, has an important bearing on the three factors already discussed. Usually a surplus fund is created for a comparatively short time, and it is to the interest of the company to provide against too great a fluctuation in the market value of the securities bought with the surplus fund. Since the prices of high-grade securities that have a long time to run before maturity are largely influenced by current money rates in relation to the respective yields of these securities, it is usually advisable to place surplus funds in short-time maturities.

The yield on a bond, for instance, is not computed solely by dividing the interest rate by the quoted price. As we have already seen in Executive Manual 43, adjustments must be made by figuring the difference between the quoted price and the par value, and the number of years the bond has yet to run. Quite obviously, then—

A high-grade security having a near maturity date will fluctuate in price within more narrow limits than a security having a long time to run.

Diversification. “Do not put all your eggs into one basket.” This adage, old as it is, is too often overlooked by investors. Where an investment fund is large enough to admit the purchase of a number of securities (say in units of \$1,000 or \$5,000), there should be a real attempt made to acquire investments of diverse natures. Especially should care be taken not to put too much money into a single outside business enterprise, into a single line of business, or into a restricted territory.

A rubber-goods manufacturing company put most of its surplus funds into securities of suppliers and distributors during the period of prosperity that preceded the business depression of 1921, which hit the whole rubber industry a heavy blow. Thus, at the very time when the company most needed its surplus funds, it found its investments greatly depreciated in value.

While we saw in our study of the safety factor that risk is to be avoided as far as possible, we know that even the most scientific calculations may be twisted by future developments. Therefore, we should always observe this important principle of diversity in making outside investments:

It is advisable to scatter investments among lines of business so dissimilar that adverse market fluctuations or industrial conditions will not render the whole investment fund impotent at any one time.

Market Conditions. The yield which may be obtained on an investment of surplus funds, consistent with desir-

able features of safety, marketability, and maturity, will depend largely on conditions prevailing in the money market at the time securities are purchased. If interest rates are high, a relatively high yield may be obtained, and sometimes under such circumstances it may be wise to buy long-term bonds, notes, and mortgages, and profit by their ultimate appreciation in value when, in the course of events, interest rates decline.

But it is not always possible to choose the time for investment. Interest rates may be high right when a firm most needs its surplus funds in its own business; or the purchase of securities at fairly low prices may be out of the question. Nevertheless, prevailing money conditions should always be considered as a factor in determining how to invest surplus funds outside the business, with this express reservation—

Safety and marketability are the two most important features desirable in securities purchased with surplus funds.

Using Surplus in the Business. One of the most frequent disappointments business men have to face is to see an attractive opportunity for making increased profits and to have no means at hand with which to finance expanded operations. Lack of ready money has compelled many a concern to pass up what proved to others a golden opportunity. Thus the importance of accumulating surplus funds where it is possible to set them aside out of earnings without crippling normal growth and without depleting necessary operating capital. The man who prides himself on "putting every penny back into the business" is very likely later to see his mistake in not having some extra money ready for quick use.

Building up a surplus for present or future use in the business is a vital principle of sound financing; it enables management to exercise judgment in choosing the right time and use for surplus in the expansion of the business.

Uses of Surplus Summarized. All of surplus, or parts of

it, may be used profitably for various purposes, all of which have as their aim increased net profits for the business as a whole. Some of the common uses of surplus are:

For experimental work in developing and perfecting products and processes.

For investigational work to test the demand for products prior to placing them on the market.

For new construction or additions to present plant and equipment.

For temporarily financing an abrupt increase in sales and production.

For extending selling and distributing facilities, as thru establishment of branch offices, warehouses, etc.

For special purchasing in unusually large quantity.

For financing the addition of new products or services.

For financing an advertising campaign.

For maintaining a good dividend-paying record.

It is well also to emphasize again the necessity of providing sufficient liquid capital to keep all financial operations running smoothly. The accumulation of surplus funds may help in current financing, especially if these funds are invested in high-grade, marketable securities; then, if a shortage of cash arises, it can be met by liquidating the securities on a favorable market or by placing them as collateral to secure short-term loans.

Having Too Much Cash on Hand. Having too much cash on hand has its dangers as well as having too little. To have a lot of cash at your command and not to have planned carefully for its profitable use or investment is likely to lead to overexpansion along an ill-advised line or to unwise speculation. At least it may result in extravagant expenditures.

Ordinarily your banker can indicate what he considers a minimum deposit balance for you to carry, based on your borrowing needs and on the line of credit to which you are entitled. By calculating how much operating capital you will need in the regular course of busi-

ness to enable you to carry on each month, and by comparing this with the banker's minimum deposit requirements, you can arrive at a close estimate of the cash balance to carry. It is necessary to analyze the cash account with a view toward calculating its size in proportion to the needs for cash. In so doing it is well to consider some of the possible uses of ready money.

The Uses of Ready Money. With ready money a business can take immediate advantage of many opportunities which might otherwise be closed to it. Buying a bankrupt's stock is sometimes a profitable move, and the cash purchaser gets the stock.

Readiness to take advantage of unusual opportunities for profitable deals of many kinds is gained by having surplus cash funds on hand.

Located in a farming community, a progressive merchant can take cash discounts in season and out of season if he analyzes his business and his location with a view toward providing a surplus to tide over lean collection times. Extra money used wisely at the right time enables a merchant to take advantage of discounts and to keep his stock up regularly so that he always has a satisfactory variety of merchandise to sell.

While collections should always be closely followed, yet there are instances when worthy customers, thru no fault of their own, need a financial "lift." If funds are available, it is possible to extend a special credit service which will later bring a satisfactory return thru the good will thus created.

There are numerous other channels for using extra money profitably and wisely, but individual opportunities of business men vary so widely that it is possible only to suggest types of uses to which surplus funds can be put.

One retail merchant who had accumulated funds over and above those needed in the regular course of his business used his surplus in trying out new lines of goods.

He was thus constantly experimenting in the wants and desires of people. People were attracted by his displays of novel things. He thus advertised the store's enterprising methods, and earned extra profits from increased sales. This is an idea that can be adapted to manufacturing and other lines of business. Any losses that result from experimenting in this way have no adverse effect on the financial standing of the business; and in the long run the gains ought to exceed the losses. However, this principle of experimenting should not be loosely applied. Testing a market should always be done as economically as possible.

One wholesale house puts away its extra funds until it has enough to establish a new branch. Then it builds the required warehouse and equips it properly. The general manager of this house says:

"We carefully invest in safe bonds or stocks at a reasonable rate of income. Then as fast as this surplus builds up to the point where we can use part of it for branch expansion we go ahead without any financial strain."

Another wholesale house puts some of its surplus into pensions and welfare activity for employees. While the return on this method of investment can be measured only indirectly, it is nevertheless of considerable worth in the greater employee loyalty and enthusiasm engendered, as will be explained fully in a later division of this training service on managing men.

Other purposes for which extra money can be used profitably include the securing of a better location; testing out a new product or investing in a side-line proposition; surviving unintelligent competition; getting options on or buying valuable property; installing a new experimental department; and so on.

There are plenty of uses for surplus funds; the point is to use them most wisely, with due consideration for the welfare of the business as a whole.

Financial Statistics Useful in Planning Expansion. The value of carefully made analyses of financial conditions as interpreted from financial statements should never be overlooked by management when it lays out its plans for expansion. The various analytical tests described in Executive Manual 44 should be applied for the purpose of determining the ability of the business to carry the increased financial burdens imposed by expansion.

Future needs can be accurately forecast with the aid of budgets intelligently drawn. In fact, close observation of all the important principles contained in the eight manuals of this section of our training service on financing a business is necessary for the realization of profitable growth.

Let us now, briefly, round out our study of financing by taking a bird's-eye view of the necessity of applying the practical considerations brought out in previous executive manuals.

FINANCING FOR EXPANSION

Part III

DEVELOPING FINANCING ABILITY

WE HAVE seen again and again that financing is inseparably connected with all other activities in a business. The best of financial management can be rendered ineffective by inefficiencies elsewhere in a business; and an enterprise with every promise of profitable production and sales activities may be ruined by having its finances mishandled—whether the business is large or small.

Always Consider the Effect on Financing. Successful business management requires not only a complete knowledge of the actual trading and producing activities involved, but also a sound understanding of the effects of each one of those activities on the problem of adequately financing the business. Many a good concern has come to grief thru being managed by a “one department” man, who leaned too heavily upon his knowledge of sales or of production alone—and who did not strengthen the finances of the business by applying the simple but important principles of good financing.

Take sales activities, for example, in their relation to financing the business. We should not let sales volume outrun our financial ability to take care of all the expenses that may accumulate before we receive the proceeds of our sales. We know that there is a limit to the volume of sales that can be safely handled, fixed by our resources available to finance production, administration, and marketing on a larger scale. There must also be sufficient financial strength to carry us thru to the time, which sooner or later comes, when we cannot as promptly collect payment for what we sell.

On the other hand, we know that sales volume must

keep pace fairly well with production; we must avoid accumulation of stocks which tie up our working capital. Our skill in adjusting production to sales (whether we are operating a factory, a store, or a business of any kind) has a great deal to do with properly financing our business. And we should remember that a volume of business which we might safely handle during a period of easy credit may be an unsafe volume at a time when credit is restricted and the facilities for borrowing are much reduced. Here we recognize the need for someone in the business who can keep his finger upon the pulse of general business conditions. Not only must he know the conditions ruling in the particular industry in which his firm is engaged, but also he must realize in what ways those conditions are being affected by outside factors—factors that have to do with money rates, commodity prices, the crop outlook, politics, and so on. All businesses are interrelated, and what affects the commercial and industrial body as a whole will affect, more or less directly, every constituent member of that body.

Know More Than Your Own Market. A good financing executive, therefore, knows not only the needs of his own particular market but also the needs of those markets which are dependent for their supplies upon his market. Nearly every business is but one link in a chain. A concern supplying an output of raw material carries on its own books the accounts of the manufacturers using that material. But if the demand for these manufacturers' products suffers a serious decline, the supplier of raw material suffers a decline. Hence the necessity of looking ahead to the ultimate consumption of a product or service, in forecasting changes which may affect financing operations. Hence, also, the necessity of studying all potential markets, so that distribution will be least seriously affected by unfavorable developments in any particular territory or line of business.

We have seen how foreign sales are financed, how the

exporter can get his money in a reasonably short time on foreign sales, by the use of bank acceptances. This suggests the possibility of selling more abroad as a means of getting more even and wider distribution.

Good financing, in all cases, takes a broad view—an outlook that comprehends world trade in general.

Even if a concern is operating in a closely restricted territory, its owners cannot afford to lose sight of general business conditions, many of which have far-reaching effects that penetrate into all lines of trade and industry. Always, unevenness in the volume of sales and output in any business puts a strain on the work of financing that business.

The Personal Factor in Financing. It has been the purpose of this division of our training service to remove the "mystery" that has surrounded the subject of business financing—to reveal it as a subject, not of magic formulas, but of common-sense principles, and to indicate the wide range of its scope, for it comprehends the entire field of industry and commerce.

Before concluding, however, we should emphasize one vital principle around which all successful financing revolves:

Valuable as is the knowledge of the principles of financing, yet far more valuable are those human qualities without which all financial rules are useless. These qualities are: vision, mastery of details, general business understanding, and that courage which carries the wise policy thru to success.

Let us consider, then, these human qualities as they make possible judicious financial planning and able handling of financial problems. Management cannot hope to decide correctly on every financing question—not even if it maintains a vigorous, courageous policy—but it should aim to pursue its course with the minimum of mistakes.

An analysis of the reasons that underlie the necessity

of having, or developing, the five essential personal qualities above mentioned follows. This analysis will serve as a review of many of the practical points to be remembered in the work of actively financing a business. Note how many of these points relate to efficient management in the various departments of a business.

1. *Financial Alertness* is required to avoid—

Starting a business with insufficient capital.

Having insufficient capital to keep going during a period of rising prices.

Bad apportionment of capital outlay—too much capital in fixed assets and too little for financing current operations.

Letting overhead expenses consume too great a portion of gross profits.

Taking too much money out of the business for private use, when such money is needed in it for development.

Failing to build up a safety fund for emergencies, and relying too heavily on credit facilities.

Failing to take cash discounts.

Extending too much credit to customers, and with too little care.

Showing too little energy in effecting prompt collections; failing to recognize that in many quick-turnover businesses Mr. "Slow-but-Good" Customer is not worth having.

Too great a tendency to "throw good money after bad"; failing to "write off" a debt definitely shown to be uncollectible.

2. *Seasoned Judgment* is required to avoid—

Failure to recognize that, owing to the nature of the undertaking, only a slow turnover can be expected. (The slower the turnover, the larger the necessary working capital.)

Overestimating the popular demand for the product; making an insufficiently careful survey of the market.

Underestimating selling resistance.

Establishing a business at the wrong time in the trade cycle; namely, on an ebb tide, when the public's buying power is declining or just before a turn downward.

Engaging in a business of a highly seasonal character without sufficient capital to finance seasonal peaks.

Choosing an unprofitable location—either for production or for distribution—causing difficulty in procuring labor in suf-

icient quantity, in easily obtaining raw materials at reasonable transportation cost, in reaching a marketing point accessible to the trade, etc.

Pushing the development of certain lines without making a careful study to show whether it will pay.

Failing to see quickly on what lines it will pay to specialize.

Unwise expenditures for advertising.

Failing to support the advertising properly, whether in distribution or in quality of service or goods.

Failing to give proper support to agents' selling efforts.

Establishing unwise policies with respect to sole agencies—allowing too small profits to distributors.

Failure to estimate correctly the amount of working capital needed.

Neglecting to cut down inventories and commitments thru inability to foresee approaching business depression.

3. *Organizing Ability* is required to avoid—

Unbalanced production and selling efforts resulting in restricted outlet for product, or delays in deliveries.

Lack of co-operation between departments.

False economy thru endeavoring to hire competent executives too cheaply.

Wastes in production due to poor planning.

Inefficient organization of office activities.

Burdensome selling costs.

4. *Moral Courage* is required to avoid—

Resistance against "pocketing" an "unavoidable" loss.

Failure to remember that satisfactory turnover of operating capital cannot be secured automatically; that it must be stimulated by active, aggressive measures.

Failure to recognize that, under certain conditions, cash is more useful than unsold goods, even if loss is involved in obtaining it.

Lack of confidence when asking for a loan at the bank—having the wrong attitude toward the bank's prime function.

5. *Diplomacy* is required to gain—

The co-operation of bankers and others who lend money or credit.

The confidence and good will of employes, suppliers, and customers.

Thus it is plainly evident that good financing requires the application of common-sense principles in dealing with a wide range of activities in any business. Management must realize that certain human qualities are required in successful financing, such as broad vision and courage, honesty and diplomacy. These qualities make it possible to establish a wise financial policy and to carry it thru to its ultimate goal—the earning of greater profits. These greater profits come from—

1. The influence of good financing upon efficiency in conducting all departments of the business.
2. Direct savings in the cost of outside funds used in financing the business.

The financial manager in particular must understand what constitutes good management in every department of his business.

Our next division of this training service, on credits and collections, is closely allied with that which we have just covered; and it, too, is closely related to every department of the business, for efficient credit and collection activities are necessary to make the income from goods or services produced and sold available for fresh purchases; for meeting pay rolls; for paying interest, taxes, rents, etc.; and for paying dividends.

It will be well for the thoro student to perfect his understanding of financing principles by handling the general review check-up and Executive Problem 48, which follow, thus completing preparation for the next major section which begins with an executive manual on the fundamentals of credit management.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of financing, presented in Executive Manuals 41-48, firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	CHECK	
	Yes	No
1. A farm-implement dealer in a Kansas town had invested \$8,500 of his own funds in the business. His outstanding indebtedness consisted of the following items: notes payable to First National Bank, \$3,200; note payable to Roscoe Beach, \$1,500; owed to Linden Tractor Company, on account, \$2,800; notes payable to McLeod Reaper Mfg. Co., \$2,600. Was his total borrowed capital \$7,300?		
2. In the spring of 1925, Roy Grayston secured a patent on a household appliance which promised to have fine sales possibilities because of its labor-saving and convenience qualities. He wanted to organize a corporation to manufacture this appliance. Would you have advised him to use, as one of the bases in fixing capitalization, the estimated future earnings of the business?		
3. The Flanders Corporation, an oil-refining company, needs additional permanent capital for use in expanding its output. Its credit position is high. Is there an advantage in issuing 7 per cent preferred stock over issuing 6 per cent debenture bonds?		
4. The Burwell-Farris Corporation, manufacturing wall board, had financed its operations successfully up to 1922 without having to resort to long-term borrowing. At this time prospects seemed favorable for increasing the output considerably; however, the company did not have sufficient capital to finance operations on a much larger scale. Its earnings record had been good, and its plant was free from liens. Some of the officers were in favor of raising a considerable sum thru an issue of first-mortgage bonds. There was no question that the company could get the additional business and make a substantial profit. Basing your judgment on the facts here presented, would you favor the bond issue?		

		CHECK																																													
		Yes	No																																												
5. The directors of the Ajax Specialty Manufacturing Company were discussing the purchase of \$15,000 worth of new machinery. “We’ve got to get that money in a hurry,” said the general manager, “and what stumps me is where it is coming from.” Van Dorn, one of the newer members of the board, was bending over the balance sheet shown below. <table><tr><th colspan="2">ASSETS</th><th colspan="2">LIABILITIES</th></tr><tr><td>Machinery and Equipment</td><td>\$ 75,000</td><td>Capital Stock</td><td>\$ 60,000</td></tr><tr><td>Supplies</td><td>10,000</td><td>Notes Payable</td><td>7,500</td></tr><tr><td>Raw Materials</td><td>18,500</td><td>Accounts Payable . . .</td><td>10,000</td></tr><tr><td>Work in Process . . .</td><td>9,000</td><td>Accrued Wages</td><td>3,500</td></tr><tr><td>Notes Receivable . . .</td><td>4,000</td><td>Reserve for Depreciation</td><td>15,000</td></tr><tr><td>Accounts Receivable</td><td>10,500</td><td>Reserve for Bad Debts</td><td>1,000</td></tr><tr><td>Cash</td><td>1,500</td><td>Surplus</td><td>32,550</td></tr><tr><td>Prepaid Insurance . . .</td><td>150</td><td></td><td></td></tr><tr><td>Organization Expense Deferred</td><td>900</td><td></td><td></td></tr><tr><td></td><td><u>\$129,550</u></td><td></td><td><u>\$129,550</u></td></tr></table> Suddenly Van Dorn raised his head; an idea had flashed thru his mind. “Gentlemen,” he said, “I do not see that we are facing any great difficulty. We can simply draw on our surplus, which amounts to more than twice the sum we need.” Was Van Dorn’s idea sound?		ASSETS		LIABILITIES		Machinery and Equipment	\$ 75,000	Capital Stock	\$ 60,000	Supplies	10,000	Notes Payable	7,500	Raw Materials	18,500	Accounts Payable . . .	10,000	Work in Process . . .	9,000	Accrued Wages	3,500	Notes Receivable . . .	4,000	Reserve for Depreciation	15,000	Accounts Receivable	10,500	Reserve for Bad Debts	1,000	Cash	1,500	Surplus	32,550	Prepaid Insurance . . .	150			Organization Expense Deferred	900				<u>\$129,550</u>		<u>\$129,550</u>		
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6. Was the Ajax Specialty Manufacturing Company’s ratio of current assets to current liabilities more than 2 to 1? Was its ratio of debt to net worth favorable?																																															
7. During 1925, the Norman-Levy Boat-Building Corporation made plans for increasing its capital and enlarging its operations. At this time, interest rates were low and bond prices at a high level. High-grade stocks were quoted high. The 7 per cent and 8 per cent preferred issues of many leading companies were selling above par. Would you consider the time favorable for the flotation of a common stock issue?																																															

	CHECK	
	Yes	No
8. The Abbott Company operates a department store in a thriving city of 40,000 people. It desires to borrow \$5,000 to finance the purchase of a new stock of dress goods.		
Can it use the services of a Morris plan bank to advantage?		
Of a financing company?		
Of a savings bank?		
Of a national bank?		
Of a Federal Reserve bank?		
9. The financial statements of the Baker-Fleming Manufacturing Corporation were presented on pages 8 and 10 of Executive Manual 44. Was the net working capital greater at the end of 1924 than at the end of 1923?		
Was the current ratio higher at the end of 1924 than at the end of 1923?		
Did the ratio of debt to net worth decrease from 1923 to 1924?		
Did the ratio of sales to fixed assets increase from 1923 to 1924?		
Was the inventory turnover greater in 1924 than in 1923, as indicated by the ratio, sales to inventories?		
Did the trend of the ratio, sales to receivables, indicate increased efficiency in collections?		
Was the ratio of net worth to fixed assets higher at the end of 1924 than at the end of 1923?		
Did the ratio of net income to net worth, for the year 1924, show an increase over 1923?		
10. A paint manufacturer wanted to establish a retail store in the main business district of a large city. His purpose was twofold: to gain more intensive distribution in this locality, and to stimulate demand which would be reflected in increased sales by retail dealers who handled his line in the city. Would you say the choice of a location in the high-rent district, where many people go to buy other things, would make necessary more working capital than the choice of a location off the "beaten path," where the rent would be considerably lower?		

	CHECK	
	Yes	No
11. George Phillips is planning to start a modern power laundry in an Ohio city of 60,000 population. He will offer popular laundry services from "rough dry" to "finished family." Leading manufacturers of laundry machinery will extend terms calling for 25 per cent down payment and the remainder in eighteen monthly payments. Still, the cost of the necessary equipment will make it necessary for Phillips to start with several thousand dollars' initial capital. If you were he, in what order would you value the following? That is, which would you consider most important, which next, which next? Practical experience in the laundry business. ☐ Sufficient owned funds for the initial investment. ☐ Thoro understanding of business management. ☐		
12. Would you expect a business with a rate of inventory turnover which is normally low, due to a lengthy manufacturing process, to have a high current ratio when in a healthy condition?		
13. A manufacturer of fishing tackle distributes his products thru dealers in the New England and Middle-Atlantic states. Could he lower his overhead costs per unit by gaining effective distribution in the Gulf Coast region?		
14. The radio industry is rapidly developing. Changes in equipment, in design, in application, are constantly making themselves felt on methods of production, of financing, of distribution. If you were operating a radio business, would you consider it feasible to use figures for the current year as a basis for preparing a financial budget for the coming year?		
15. The management of the Metropolitan Shoe Manufacturing Company, in forecasting their sales for the next season, determined that they could readily dispose of 3,000 pairs a day in excess of their present plant capacity. They arranged for a loan, secured by a mortgage on the existing plant. The proceeds of this loan were to be used in constructing an addition to one of the buildings and in purchasing and installing the necessary equipment. Should the loan be large enough to provide additional working capital?		

Executive Problem 48

PROVIDING CAPITAL FOR EXPANSION

Meeting the Financial Needs of a Growing Business

UNDER THE LASALLE PROBLEM METHOD



HOW much business shall a firm try to do? All it can get? Or all it can safely finance with present capital?

Shall growth be promoted thru the addition of outside capital, or shall expansion be financed solely out of earnings?

Decisions on these questions vitally affect business policy—and thus they concern every activity of the business.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

Executive Problem 48

PROVIDING CAPITAL FOR EXPANSION

The Colbrook Mills are well known as manufacturers of cotton textiles who specialize in the twill weaves. For over seventy-five years this company has been one of the leaders in the cotton-manufacturing section of Massachusetts, and in the year 1919 was still using the original buildings, to which additions had been made from time to time.

The organization was rather a family affair with comparatively few stockholders, all of whom were directly interested in the business, and all of whom were comfortably well off, since the company had been prosperous thruout its entire history. In 1919 the outstanding capital stock was \$750,000, and the surplus a little over \$700,000.

The management and the majority of the workers had been, one might say, brought up in the business. The officials had been rather unusually progressive. They had constantly studied the demands of their market, and had not hesitated to buy the latest and most up-to-date equipment. The business had been handicapped, it is true, by its obsolete buildings and plant layout, but the efficiency of the management had been such as to counteract these material inefficiencies to a great extent. As a result, the business had earned very satisfactory profits consistently.

Just after the close of the World War, the management had a considerable surplus fund on hand, which it had set aside to use in purchasing new and more up-to-date equipment. This brought up the question of housing

this equipment, so an industrial engineer was retained to study the problem. He reported that the new equipment could not be fitted to advantage into the old building. For its ceilings were low; its windows small; its lighting and ventilating were below present-day standards; and it was entirely impractical to make the radical changes necessary to effect improvement.

The engineer estimated that the same number of operators as were then employed could turn out 25 per cent more cloth if the new equipment were installed in a plant especially designed to house it. There would also be a large saving in indirect labor. These advantages would be gained largely as a result of improved layout of machinery and improved internal transportation facilities.

He stated, also, that the working conditions would be very materially improved in the new plant, so that the tendency toward high labor turnover which the management had noticed could be checked. He pointed out, further, that in a new plant the artificial lighting could be made so effective as to permit the working of all machines on double shifts, should that be necessary. This would virtually double the plant capacity. (Double shifts had proved impractical in the old plant, since the quality of the night work had always been poor because of the effects of improper lighting.)

These considerations carried great weight with the executives, since the demand for the company's goods exceeded the plant capacity, and since working conditions were causing many trusted employes to talk of leaving—men who were, to a great extent, responsible for the high quality which enabled Colbrook fabric to command a price preference over competing lines. The management had estimates made on the cost of a new building. These proved very high, for it will be remembered that this was the boom period just after the close of the World War. There was no indication, however, that building costs would soon become lower. The new equipment was badly needed and contracts had already been placed for it, so the big question that had to be decided at once was: Should this equipment be installed in the old plant?

The estimates showed that the new plant would cost some \$1,100,000, or \$750,000 net after deducting \$350,000 which the company expected to receive for the property it was now occupying. This property was, in a way, too valuable to use for mill purposes, since the business section of the city had built up all around it. It was planned to put the new plant a little farther out.

Profits had for some years been very good. The net current assets were more than \$800,000. The current ratio was a little better than 4 to 1. There seemed every prospect that profits would continue, and that the excess of current assets over current liabilities

would increase to \$1,200,000 before the plant could be completed. (In giving these figures, you will observe that the new equipment was considered as having already been paid for, since reserve funds had been set aside for that purpose.)

Most of the directors favored building a new plant. The president was inclined to agree, but insisted that if they went ahead, the favorable financial position which the company then enjoyed should not be jeopardized. Instead of paying for the new building all out of current assets as some of the directors preferred, he insisted that \$400,000 should be raised as new capital, and that no more than \$350,000 should be taken out of current assets.

This was agreed on. The \$400,000 was raised by selling additional stock. Work on the new building was begun.

Hardly had the work progressed to the point where it could not be stopped when it became evident that the business cycle was entering the hectic phase of a boom period. Prices for all materials soared. The building costs proved one-fourth greater than the estimates. The company's margin of profit on sales became less, because it was compelled to pay higher prices for materials and supplies, to increase wage scales, and to pay higher taxes.

And then came the depression. Many orders were canceled by customers. The company was left with stocks of finished goods which had been manufactured out of high-priced material and with high-priced labor. Orders became more and more difficult to secure.

The management had anticipated many of these developments and so handled the company's affairs during these trying months that at no time did the business go "into the red." Profits, however, dwindled very nearly to the vanishing point. Inventories were courageously written down to the cost values.

By the time the building was completed, the new equipment installed, and the workers moved in, the volume of work was but two-thirds of the previous normal. Also, the market for the company's real estate had disappeared. The vacated property was still unsold, and there were no immediate prospects of selling it.

The extra cost of the new plant and the material decrease in net profits were reflected in the balance sheet of June 30, 1921, which is here shown.

This statement shows that current liabilities were in excess of current assets, and that the vacated property was being carried as a special asset at \$50,000 less than the company had hoped to receive for it when the expansion plans were first outlined.

THE COLBROOK MILLS

Balance Sheet as of June 30, 1921

Assets:

Cash on hand and in bank.....	\$179,382.51	
Accounts receivable for goods.....	470,287.60	
Notes receivable from stockholders....	10,500.00	
Inventory (at present costs).....	622,323.30	
Total current assets.....		\$1,282,493.41
Deferred charges.....		23,420.00
Real estate held for sale.....		300,000.00
Plant and equipment, less depreciation.....		1,952,496.42
Total assets.....		3,558,409.83

Liabilities:

Accounts payable for supplies.....	\$ 103,762.42	
Notes payable held by banks.....	1,223,000.00	
Total current liabilities.....		\$1,326,762.42
Reserve for taxes.....		29,576.00
Other reserves.....		291,477.73
Capital stock outstanding.....		1,000,000.00
Surplus		869,214.45
Undistributed profits		41,379.23
Total liabilities		\$3,558,409.83

The company's bankers had shown themselves very tolerant of the situation, because of their confidence in the ability of the management.

However, in the spring of 1921, they concluded that they had carried the notes of the company as long as prudence permitted, and demanded that the company arrange its finances on a more normal basis.

In the working papers you will analyze the steps taken in this company's expansion program, and will outline a plan by which you would have set its financial house in order.

